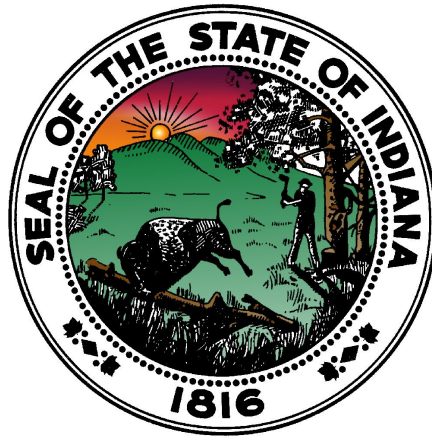


# **Tax Competitiveness and Simplification Report**

Recommendations from the Indiana Tax  
Competitiveness and Simplification Conference



September 2014

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## EXECUTIVE SUMMARY

On June 24, 2014, Governor Mike Pence hosted a day-long conference on Tax Simplification and Competitiveness as part of a comprehensive review of Indiana's tax structure. The conference brought together more than 100 tax experts and stakeholders from around the state and nation. The purpose of the Tax Conference was to undertake a frank and forthright discussion of what steps are necessary to improve Indiana's tax structure. Speakers discussed fundamental tax principles, specific tax types, and ways to simplify taxes for families and businesses. Based on that conference, public submissions, and other research, this report has been prepared by the Department of Revenue, Department of Local Government Finance, Economic Development Corporation, and Office of Management and Budget. It is hoped that this report will provide a guide to the General Assembly, identifying Indiana's tax weaknesses and ways to address those weaknesses.

In general, a competitive tax structure rests upon sound principles. **Simplicity** allows taxpayers to easily understand and comply with the rules. **Transparency** enables taxpayers to forecast their total tax liability and comprehend the state's tax structure without hidden costs. **Stability** provides consistency and predictability, which encourages entrepreneurship and economic growth by allowing taxpayers, and government, to plan for the future. **Fairness** and **neutrality** ensure that the tax code treats similar taxpayers similarly. **Competitiveness** creates an environment in which individuals and businesses seek to locate and expand in the state. Finally, a **broad tax base**, coupled with **low rates**, produces consistent tax revenues while minimizing economic distortions.

As explained during the Tax Conference, Indiana's tax system enjoys many positive features. For instance, Indiana has a flat individual income tax rate and low business tax rates. During the past two legislative sessions, Indiana repealed its inheritance tax, lowered tax rates on individuals, lowered tax rates on corporations and financial institutions, and gave local communities more options to lower business personal property taxes. For these and other reasons, the nonpartisan Tax Foundation ranks Indiana's corporate business climate as 10th best in the nation.

In other respects, however, Indiana has substantial room for improvement. Indiana's tax structure dates from the 1950s, more than a half-century ago, and some elements of the tax code date from the 1930s. According to some panelists, Indiana's sales tax base has narrowed too much over time, as certain sectors of the economy have grown. Similarly, Indiana's corporate tax code creates numerous ambiguities, which leads to needless litigation in courts. Finally, Indiana's business personal property tax discourages investment in new technology and equipment, the engines of growth and jobs.

Over time, Indiana's tax code has grown more complex and less transparent. For instance, because of numerous new deductions and credits, Indiana's individual tax forms and instruction booklets have more than doubled in size over the past two decades. In many instances, Indiana favors certain industries over others and carves out entire categories of income

from taxation altogether. These types of special tax breaks and credits slow the economy, distort the flow of capital and labor, and result in higher overall tax rates. Similarly, due to endless tinkering with the tax laws, neither taxpayers nor the government have confidence in the stability of the tax system. According to the non-partisan Progressive Policy Institute, Indiana's tax code ranks among the most complex in the nation.

By updating and simplifying its tax system, Indiana could improve its competitiveness in the national and global economies. Businesses regularly complain about outdated, burdensome aspects of the tax code. A simpler tax code would lower compliance and litigation costs, create a more level playing field, and incent companies to bring and create more jobs in Indiana.

This report discusses most of Indiana's major tax types, including numerous specific proposals that would allow Indiana to simplify its tax system. The report also touches upon the potential fiscal impact of many of the proposals. On their own, some of these specific proposals may result in more revenue to the state, while other specific proposals would result in less revenue to the state. Overall, this report recommends that Indiana reshape its tax system in ways that remain **revenue neutral**.

Indiana has numerous options to simplify each of its major tax types. This report will discuss simplification options for the following tax categories:

- **Sales Taxes.** Indiana should consider broadening its sales tax base to include additional sectors of the economy, thereby allowing for a lower overall rate. As the economy has grown and changed, Indiana's sales tax base has become very narrow. By broadening the sales tax base, Indiana could lower its sales tax rate – or lower or eliminate other tax rates – and increase the tax code's progressivity. Indiana also could stabilize its tax base to decrease the volatility of revenue cycles. Moreover, Indiana could simplify sales taxes in many other ways. For example, Indiana should simplify the exemption for business and agricultural inputs. Businesses regularly complain about Indiana's rules, which rank among the nation's most stringent.
- **Individual Taxes.** Indiana should simplify its individual income taxes by reducing the number of modifications and exemptions. By doing so, Indiana would reduce the amount of time, and money, that Hoosiers have to spend doing their taxes, with little or no fiscal impact. Over the longer term, Indiana should consider restructuring its tax code to move away from taxes on income and toward taxes on goods and services. Substantial empirical research suggests that income taxes inhibit economic growth and slow the creation of new jobs.
- **Corporate Income Taxes.** In the short term, Indiana should modernize its tax code to better capture corporate income that is earned in Indiana. In particular, many other states have adopted market-based sourcing and a broader definition of corporate income. At the conference, panelists also raised the issue of mandatory combined reporting. In general, these changes would allow Indiana to cut the overall corporate tax rate, which would benefit all businesses. Over the longer term, Indiana should lessen its reliance on

corporate income taxes. Indiana collects only about 5% of its annual budget from corporate income taxes. Many economists believe that states should not tax corporate income, as corporate taxes are expensive and difficult to administer. Moreover, repealing this tax would improve Indiana's business climate substantially – the three highest-rated states for tax climate have no state corporate income tax.

- **Local Option Income Taxes.** All 92 county-level governments have the authority to enact a Local Option Income Tax (LOIT), which fall into three categories – County Economic Development Income Tax, County Adjusted Gross Income Tax, and County Option Income Tax. Each category has its own unique set of parameters, guidelines, rates, and restrictions. Over time, Indiana's LOIT landscape has become a veritable patchwork of 92 different LOIT schemes. Further, by design, property tax caps have increased local governments' reliance on LOITs for basic funding of services. As the exceptions to maximum rates have been allowed in statute and as other LOIT subtypes have been introduced, the LOIT statutes and adoption process have become increasingly complex. By simplifying and reducing the number of LOITs, Indiana could increase the flexibility for local governments and reduce the risk of future errors.
- **Property Taxes.** Indiana should continue to seek opportunities to streamline its property tax system, particularly with respect to the filing and administration of business personal property taxes. Some of the options for streamlined filing include consolidated returns at either the county or state level, online filing of returns, and revised business personal property tax forms.
- **Other Taxes and Special Taxes.** Indiana receives significant revenue from a variety of other sources, including fuel, cigarettes, utilities, and financial institutions. In 2013, these taxes accounted for more than 16% of all tax revenues. Most of this revenue is obtained through excise taxes and is used for specifically designated purposes, though some of this revenue is sourced to the general fund. Many of these tax categories would benefit from legislative updates to address new products, out-of-date definitions, and other inefficiencies.
- **Tax Incentives.** Most empirical economic studies indicate that tax incentives produce little real economic investment or jobs, but that they force governments to impose higher overall tax rates. Accordingly, Indiana should reduce its reliance on tax incentives, at both the state and local levels. At a minimum, Indiana should carefully reevaluate all existing tax incentives.
- **Tax Administration.** Indiana should consider several reforms to ensure that the tax administrative agencies and the judiciary provide taxpayers with prompt and fair guidance regarding the process for filing taxes and for resolving disputes. For example, the statutory and regulatory procedures for protesting assessments do not match the procedures for refund protests, causing needless administrative confusion and

inefficiency. Indiana also should devote more resources to the dispute resolution process to assure Hoosiers of both due process and timely judicial decisions.

As Indiana considers options to simplify its tax system, Indiana should ensure that it has garnered the support of all major stakeholders, including individual taxpayers, the business community, and local governments. In other states, tax reform proposals have failed because one or all of these groups vehemently disagreed with them. Where states achieved meaningful tax changes, they focused on sound principles and brought all stakeholders into the process.

Finally, and perhaps most importantly, Indiana has every reason to review and simplify its tax system. At the Tax Conference, many speakers pointed out that other states are working aggressively to improve their business climates and tax systems, both in the Midwest and around the nation. For these reasons, Indiana must continue to innovate and improve its tax climate – or risk falling behind its neighbors and competitors.

### *I. History of Taxation in Indiana*

Indiana's tax structure has evolved over time. For much of the nineteenth and early twentieth centuries, real and personal property taxes, along with poll taxes, primarily funded state and local governments. In 1913, Indiana imposed one of its first major state-wide taxes, the inheritance tax.<sup>1</sup> In 1933, Indiana began to develop a sophisticated state-wide tax system. The state imposed a gross income tax on individuals, corporations, and other entities. The gross income tax was a broad-based gross receipts tax, with very limited deductions and exemptions, on Indiana transactions such as sales and wages.<sup>2</sup> Indiana also enacted an intangibles tax on stocks and bonds, along with taxes on banks, trusts, building/loan associations, and various alcoholic beverages.

In 1963, the state imposed a 2% adjusted gross income tax on individuals, corporations, and trusts.<sup>3</sup> As a testament to its original simplicity, this tax allowed only five modifications for individuals and three for corporations.<sup>4</sup> Additionally, the only allowable credits were for taxes withheld on wages, gross income tax, and taxes paid to other states for individuals.<sup>5</sup> Also in 1963, the state enacted a 2% gross retail (sales) tax and a complementary use tax on the retail sale of tangible personal property in Indiana.<sup>6</sup>

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<sup>1</sup> Acts 1913, c. 47.

<sup>2</sup> Acts 1933, c. 50

<sup>3</sup> Acts 1963(ss), c.32

<sup>4</sup> Acts 1963(ss), c.32, s. 103

<sup>5</sup> Acts 1963(ss), c.32, ss. 301-303.

<sup>6</sup> Acts 1963(ss), c. 30

In 1973, Indiana overhauled the property tax system by placing a cap on local property taxes.<sup>7</sup> The changes permitted counties to enact a county adjusted gross income tax (CAGIT) to recoup lost revenues from property tax limits. In addition, the supplemental net income tax – a surtax imposed on the net income of C corporations – was enacted. At the same time, the corporate and sales tax rates increased to 3%<sup>8</sup> and 4%<sup>9</sup>, respectively.

Other changes followed in the next decade. Effective January 1, 1981, Indiana enacted a common set of enforcement, assessment, collection, and procedural laws for all “listed taxes.”<sup>10</sup> In 1986, the General Assembly created the Indiana Tax Court, a one-person court with no automatic right of appeal, designed to review tax decisions by the Indiana Department of Revenue and the State Board of Tax Commissioners (the Indiana Board of Tax Review and the Department of Local Government Finance have taken over the responsibilities previously assigned to the State Board of Tax Commissioners), as well as county determinations of inheritance tax. In 1989, Indiana enacted the Financial Institutions Tax on banks and other financial institutions.<sup>11</sup>

After limited changes in the 1990s, the state revisited its tax system in the first decade of this century. In 2002, the state enacted a number of tax laws. For example, the state repealed the gross income tax and supplemental net income tax, increased the corporate adjusted gross income tax rate from 3.4% to 8.5%, increased the sales and use tax rate from 5% to 6%, and imposed a new utility receipts tax of 1.4% on utility companies. In addition, Indiana substantially increased the number of add backs and deductions to the adjusted gross income tax, most notably related to depreciation. Effective January 1, 2004, Indiana revised its sales tax code to comply with the Streamlined Sales and Use Tax Agreement (SSUTA).<sup>12</sup> As a result, many statutory definitions and sourcing provisions were revised or added.

From 2007 to 2011, Indiana reformed the corporate adjusted gross income tax.<sup>13</sup> Indiana phased out the payroll and property factors for computing corporate adjusted gross income and instead adopted a single-factor receipts formula. In 2010, Indiana imposed a constitutional cap on local property taxes.<sup>14</sup> These caps are 1% of assessed valuation for owner-occupied real property, 2% for other residential real estate and farmland, and 3% for all other property. Finally,

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<sup>7</sup> Acts 1973, P.L. 45.

<sup>8</sup> Acts 1973, P.L. 50, s. 1.

<sup>9</sup> Acts 1973, P.L. 47, s 5

<sup>10</sup> IC 6-8.1-1-1 *et seq.*

<sup>11</sup> IC 6-5.5-1-1 *et seq.*

<sup>12</sup> *See* IC 6-2.5-11-1 *et. seq.*

<sup>13</sup> IC 6-3-2-2(b)

<sup>14</sup> Ind. Const. art. X, § 1(f)



between 2011 and 2014, Indiana eliminated the inheritance tax,<sup>15</sup> gave local communities flexibility to lower business personal property taxes, began to phase down the corporate adjusted gross income tax rate and the financial institutions tax rates from 8.5% to 4.9%,<sup>16</sup> and reduced the individual income tax rate to 3.23%.<sup>17</sup>

Today, most taxes in Indiana are authorized at the state level. Most state revenue derives from a sales tax of 7% and the flat rate individual income tax. “Individual income tax” includes all personal and business tax paid at the individual level and includes all sole proprietor and partnership income. The state continues to collect a local option income tax for many counties. Local governments are funded primarily by these local option income taxes and property taxes, which are set by local boards. In addition, the state collects excise taxes on motor vehicles, alcohol, tobacco, gasoline, and certain other items. Most of these proceeds fund roads and health programs. Finally, Indiana also continues to collect corporate income taxes and a myriad of smaller taxes, such as taxes on financial institutions and utilities. The Indiana Department of Revenue collects all listed taxes and deposits revenue in the general fund, various dedicated funds, or with the appropriate state and local government entities.

## *II. State Business Tax Climate*

Indiana prides itself on having an excellent business climate. According to the Tax Foundation, Indiana has the nation’s 10<sup>th</sup> best business tax climate based on factors such as the state’s relatively low tax rates and broad base. Anecdotes support this ranking. In recent years, many companies have relocated to Indiana from neighboring states, particularly Illinois. Allan Hubbard, the Tax Conference’s keynote speaker, recently moved a textile company from New York to Indiana due to its favorable business and tax climate. Despite these advances, Indiana has room for improvement.

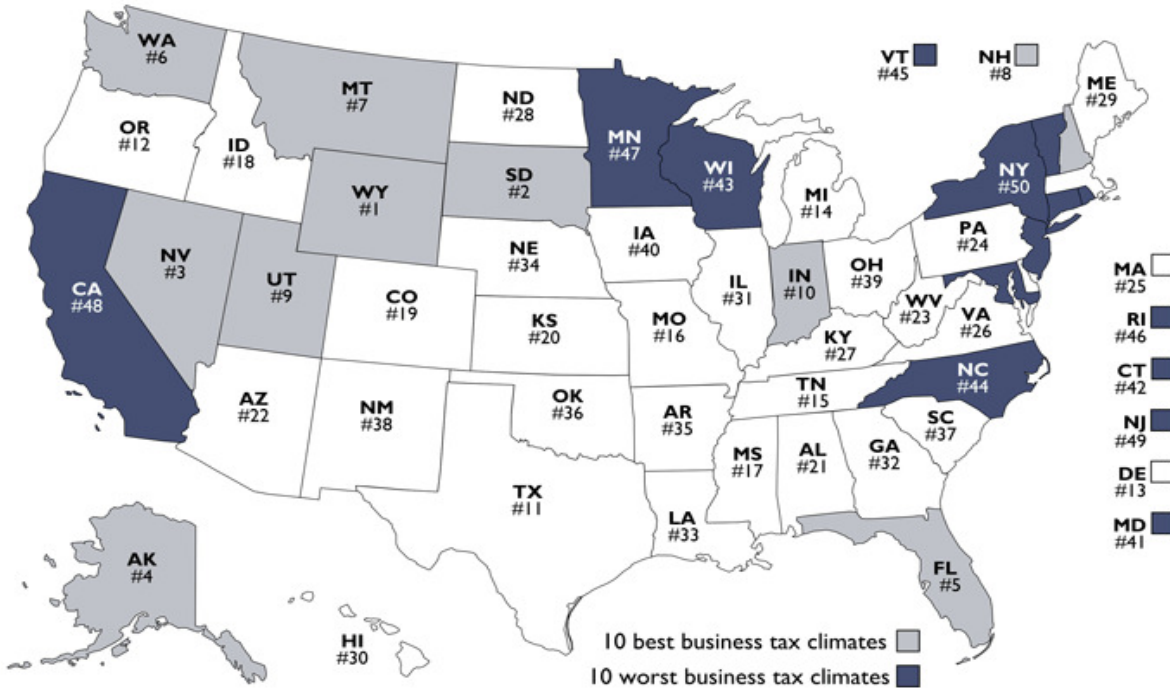
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<sup>15</sup> IC 6-4.1-1-0.5

<sup>16</sup> IC 6-3-2-1(b); IC 6-5.5-2-1(b)

<sup>17</sup> IC 6-3-2-1(a)

# 2014 State Business Tax Climate Index



Note: Published October 9, 2013.  
Source: State Business Tax Climate Index

[taxfoundation.org/maps](http://taxfoundation.org/maps)

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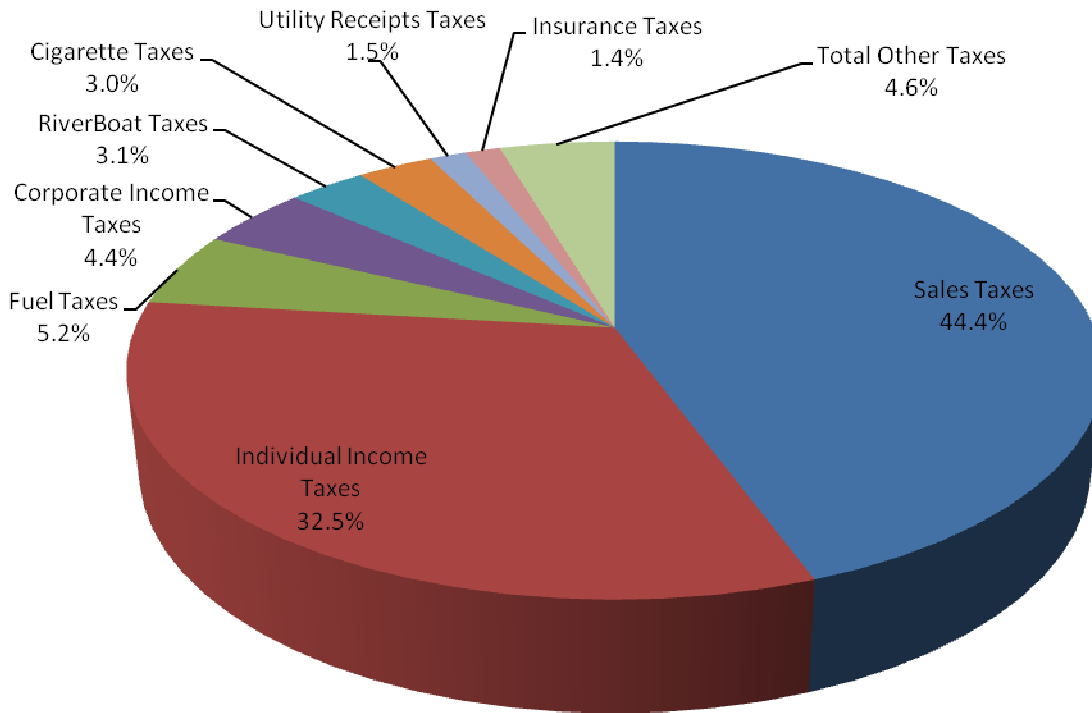
### III. Sources of Tax Revenue in Indiana

Excluding transfer payments from the federal government, Indiana receives most of its tax revenue from its sales tax and individual income tax. In 2013, these two taxes accounted for almost 80% of the state's tax revenue, or about \$11.8 billion.<sup>19</sup>

<sup>18</sup> The Tax Foundation Map of the 2014 State Business Tax Climate Index, available at <http://taxfoundation.org/blog/map-2014-state-business-tax-climate-index>.

<sup>19</sup> Please note that the pie chart includes only the state portion of tax revenues. Revenues earmarked for counties (LOIT, portions of FIT and inheritance, etc.) are not included in this graph. Figures based on information available in the *Indiana Handbook of Taxes, Revenues, and Appropriations, Fiscal Year 2013*, available at <http://iga.in.gov/legislative/2014/publications/handbooks/> (click on fiscal year 2013).

## 2013 Primary Tax Revenue Sources



Over the last decade, sales tax revenues have become a larger percentage of the state budget. Sales tax revenues have increased 43%, whereas individual income tax revenues have increased a little over 30%. Moreover, sales tax revenues have increased more than \$1 billion since the Great Recession, while individual income tax revenues, which includes income from sole proprietors, partnerships, and limited liability companies, are just now returning to pre-recession levels.<sup>20</sup> Far and away, sales taxes have become the most stable and important source of revenue for the state.

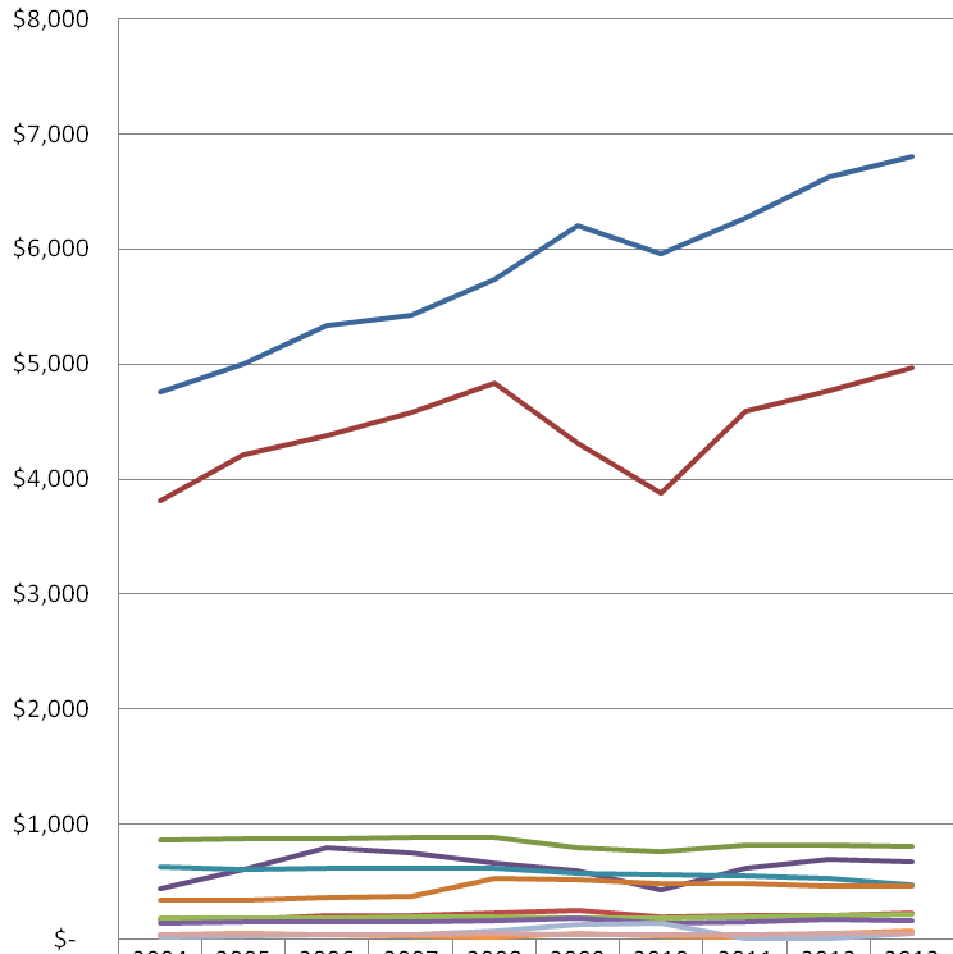
<sup>20</sup> See the included Historic Primary Tax Revenue Source table on next page. The increase in sales tax revenue is also due, at least in part, to the sales tax rate increasing from 6% to 7% in April 2008. Figures are based on information available in the *Indiana Handbook of Taxes, Revenues, and Appropriations*, various years, available at <http://iga.in.gov/legislative/2014/publications/handbooks/> (click on each fiscal year).

## Historic Primary Tax Revenue Sources

### Total State Tax Revenue (In Millions)

2004	\$11,439
2005	\$12,282
2006	\$13,026
2007	\$13,295
2008	\$14,010
2009	\$13,932
2010	\$13,153
2011	\$14,334
2012	\$14,945
2013	\$15,319

In millions of dollars



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
— Sales Taxes	\$4,759	\$5,001	\$5,337	\$5,424	\$5,739	\$6,206	\$5,964	\$6,270	\$6,632	\$6,805
— Individual Income Taxes	\$3,808	\$4,213	\$4,382	\$4,580	\$4,838	\$4,314	\$3,876	\$4,586	\$4,766	\$4,973
— Fuel Taxes	\$867	\$872	\$871	\$881	\$886	\$799	\$760	\$819	\$815	\$803
— Corporate Income Taxes	\$443	\$608	\$796	\$746	\$661	\$598	\$428	\$619	\$700	\$669
— RiverBoat Taxes	\$625	\$609	\$617	\$617	\$616	\$576	\$565	\$554	\$524	\$471
— Cigarette Taxes	\$339	\$343	\$356	\$368	\$525	\$517	\$482	\$479	\$456	\$462
— Utility Receipts Taxes	\$167	\$171	\$206	\$210	\$228	\$254	\$199	\$209	\$210	\$224
— Insurance Taxes	\$178	\$187	\$178	\$191	\$192	\$187	\$181	\$190	\$207	\$212
— Inheritance Taxes	\$140	\$151	\$149	\$150	\$166	\$186	\$133	\$149	\$176	\$166
— Financial Institutions Taxes	\$34	\$46	\$41	\$31	\$20	\$53	\$23	\$16	\$48	\$68
— Other Taxes	\$16	\$23	\$33	\$40	\$70	\$130	\$133	\$10	\$0	\$46
— Alcoholic Beverage Taxes	\$39	\$39	\$41	\$40	\$45	\$44	\$40	\$44	\$44	\$45

#### IV. The Ideal Tax System

During the Tax Conference, many speakers outlined the elements of an ideal tax system. Governor Pence noted that taxes affect every business, community, and family in the state. As he explained, “A well-designed tax structure should be simple, stable, transparent, and fair. It should reward hard work. It must encourage investment and job growth. It needs to provide stable revenues to all levels of government but allow families to keep as much of their income as possible.”

Panelist Allan Hubbard discussed the principles of effective and simple tax systems. In his view, the ideal tax structure inhibits economic growth as little as possible.<sup>21</sup> Key elements include transparency,<sup>22</sup> stability,<sup>23</sup> limiting government expenses,<sup>24</sup> preventing economic distortions,<sup>25</sup> minimizing tax rates, avoiding taxes that discourage investment, and striving to achieve fairness for all taxpayers.<sup>26</sup> At the same time, the tax code must provide a competitive

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<sup>21</sup> See also Justin Ross, Mercatus Center at George Mason University, *A Primer on State and Local Tax Policy*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-1.pdf>.

<sup>22</sup> See also Andreea Militaru & Thomas Stratmaan, Mercatus Center at George Mason University, *A Survey of Sales Tax Exemptions in the States*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-2.pdf> (also citing transparency as part of an ideal tax system).

<sup>23</sup> See also Michael J. Hicks & Dagney Faulk, Ball State University Center for Business and Economic Research, *Tax Simplicity & A Sound Tax System in Indiana*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/hicks-whitepaper-2.pdf> (also citing stability as part of an ideal tax system the important of tax neutrality); Mark W. Everson, Alliantgroup (former Commissioner of the Internal Revenue Service), *Elements of Tax Reform*, Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/everson-whitepaper-1.pdf> (explaining the importance of “permanency.”); Francina A. Dlouhy, Partner, Faegre Baker Daniels, *Thoughts on Tax Simplicity*, (June 24, 2014), <http://www.in.gov/dor/files/dlouhy-whitepaper.pdf> (noting the need for “predictability” with the tax system).

<sup>24</sup> See also Jim Eads, *Tax Simplification: Can We Get There from Here?*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/eads-whitepaper-1.pdf> (explaining that taxes should not be costly for government to administer, and taxes should be adequate to provide an appropriate level of those goods and services best provided by the public sector, such as education, public safety and transportation).

<sup>25</sup> See also Jim Eads, *Tax Simplification: Can We Get There from Here?*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/eads-whitepaper-1.pdf> (explaining that taxes should do the least harm to the private economy; tax bases should be as broad as possible so that tax rates can be as low as possible).

<sup>26</sup> See also Jim Eads, *Tax Simplification: Can We Get There from Here?*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/eads-whitepaper-1.pdf> (explaining that taxes should not only be fair and equitable toward individuals and businesses similarly situated, but they also must be perceived as fair by taxpayers); Maurice Mctigue, Mercatus Center at George Mason University, *A Primer on State and Local Tax Policy*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-1.pdf> (also citing equity as part of an ideal tax system); Michael J. Hicks & Dagney Faulk, Ball State University Center for Business and Economic Research, *Tax Simplicity & A Sound Tax System in Indiana*, Indiana’s Tax Competitiveness and Simplification Conference

environment for business but not attempt to influence the behavior of its citizens.<sup>27</sup> Perhaps most importantly, the ideal tax system should be simple.<sup>28</sup>

In keeping with these principles, Mr. Hubbard explained that credits and deductions diminish the tax system's overall fairness, transparency, and simplicity. Credits and deductions hide expenditures and are usually available to or understood by only a select few. Mr. Hubbard also stressed the need for stability to ensure predictable revenue for the state. Stability allows the state to accurately budget and manage expenses. To achieve stability, Mr. Hubbard suggested taxing activity that experiences the least change during economic hills and valleys, such as payroll taxes and taxes on goods and services. In contrast, the most destructive and volatile taxes are those on investment, equipment, and businesses in general.

With this foundation, Mr. Hubbard briefly assessed Indiana's existing tax system. He noted that Indiana has taken many positive steps, such as reducing the corporate income tax rate (a tax on investment) and eliminating the inheritance tax. Nevertheless, Mr. Hubbard identified many areas for improvement. For example, according to outside research, Indiana imposes a higher tax burden on its citizens than almost half the country. Additionally, Indiana taxes business investment and income, and due to the large number of exemptions and deductions – 17 add backs, 30 offset credits, 5 refundable credits, 5 exemptions, 26 deductions – the state's tax system lacks fairness, transparency, and simplicity. Mr. Hubbard urged the state to address these ongoing weaknesses, such as by eliminating as many deductions and exemptions as possible. According to Mr. Hubbard, these deductions and exemptions cost the state \$1.2 *billion* every year in lost revenues – and needlessly add to the complexity of the tax system. If Indiana eliminated these complex and costly deductions and exemptions, it could afford to reduce its tax burden on individuals and business investment, thus encouraging economic growth and simplifying the tax system.

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whitepaper (June 24, 2014), <http://www.in.gov/dor/files/hicks-whitepaper-2.pdf> (emphasizing the important of tax neutrality).

<sup>27</sup> See also Jim Eads, *Tax Simplification: Can We Get There from Here?*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/eads-whitepaper-1.pdf> (explaining that deviations from sound tax policy in pursuit of economic development, social, or other goals should be well-reasoned and implemented only when established tax policies are not significantly undermined and the results of such deviations can subsequently be evaluated), Mark W. Everson, Alliantgroup (former Commissioner of the Internal Revenue Service), *Elements of Tax Reform*, Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/everson-whitepaper-1.pdf> (explaining the need for sound policy before enacting tax laws).

<sup>28</sup> See also Michael J. Hicks & Dagney Faulk, Ball State University Center for Business and Economic Research, *Tax Simplicity & A Sound Tax System in Indiana*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/hicks-whitepaper-2.pdf> (also citing the need for simplicity); Mark W. Everson, Alliantgroup (former Commissioner of the Internal Revenue Service), *Elements of Tax Reform*, Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/everson-whitepaper-1.pdf> (explaining the need for simplification); Francina A. Dlouhy, Partner, Faegre Baker Daniels, *Thoughts on Tax Simplicity*, (June 24, 2014), <http://www.in.gov/dor/files/dlouhy-whitepaper.pdf> (explaining the need for general simplicity, noting that currently, Indiana has 18 modifications to federal taxable income to arrive at adjusted gross income for corporations and 32 such modifications for individuals).

## SIMPLIFICATION OPTIONS

As panelist Francina Dlouhy eloquently explained, “[s]implicity requires that something be easy to follow and make sense.”<sup>29</sup> Numerous other panelists agreed that any comprehensive review must focus on simplicity and growth.<sup>30</sup> Empirical research confirms that the more complex a taxing scheme is, the greater the uncertainty and compliance costs.<sup>31</sup>

### *Sales Tax*

#### **I. Summary**

Indiana imposes a 7% sales tax on retail transactions for most tangible personal property, other than groceries and drugs. In 2013, the sales tax provided Indiana with \$6.8 billion, 44.4% of its revenue. Retail sales taxes are one of the more transparent ways to collect revenue. A taxpayer can simply look at a sales receipt and see the tax rate and amount paid. The ideal retail sales tax distributes the cost of government according to the amount of consumption spending by each household.<sup>32</sup> In this manner, sales taxes also allow taxpayers to choose how much to pay in taxes based on how much they consume.

Indiana’s sales tax burden ranks in the middle of the country. Forty-five states collect statewide sales taxes, and 38 states collect local sales taxes.<sup>33</sup> The three states with the highest average combined state-local sales tax rates are Tennessee (9.45%), Arkansas (9.19%), and Louisiana (8.89%). Although Indiana’s 7% state-level sales tax rate ranks as the second highest in the nation, Indiana ranks 21<sup>st</sup> in the nation regarding combined state and average local sales

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<sup>29</sup> Francina A. Dlouhy, Partner, Faegre Baker Daniels, *Thoughts on Tax Simplicity*, (June 24, 2014), <http://www.in.gov/dor/files/dlouhy-whitepaper.pdf>.

<sup>30</sup> Michael J. Hicks & Dagney Faulk, Ball State University Center for Business and Economic Research, *Tax Simplicity & A Sound Tax System in Indiana*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/hicks-whitepaper-2.pdf>; *See also* Mark W. Everson, Alliantgroup (former Commissioner of the Internal Revenue Service), *Elements of Tax Reform*, Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/everson-whitepaper-1.pdf> (explaining that simplification of the tax system is necessary for taxpayers to comply with and the government to enforce the tax code).

<sup>31</sup> Michael J. Hicks & Dagney Faulk, Ball State University Center for Business and Economic Research, *Tax Simplicity & A Sound Tax System in Indiana*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/hicks-whitepaper-2.pdf>.

<sup>32</sup> John L. Mikesell, *Reform and Simplification of Indiana State Taxes: the Retail Sales Tax*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/whitepaper-mikesell.pdf>.

<sup>33</sup> *See* Tax Foundation, Combined State & Average Local Sales Tax Rates in 2014 chart, *available at* [http://taxfoundation.org/sites/taxfoundation.org/files/docs/state-local-sales-taxes-2014-\(large\).png](http://taxfoundation.org/sites/taxfoundation.org/files/docs/state-local-sales-taxes-2014-(large).png).

tax rates because the state does not permit local sales taxes.<sup>34</sup> Not surprisingly, due to Indiana's relatively high sales tax rate, the state brings in slightly more than the national average in state sales tax collections per capita.<sup>35</sup>

Panelist Maurice McTigue provided a good overview of sales taxes and their policy benefits. As he explained, "[c]onsumption taxes are levied against spending on household goods and services. With respect to efficiency, [sales] taxes are favored as an alternative to income taxes by those wary of tax systems that punish savings. [Sales] taxes are generally considered regressive, although [sales taxes] [are] arguably a better indicator of ability to pay among individuals with the same amount of annual income. Regressivity can also be modified by selective exemptions. Indiana currently has 46 statutory exemptions from sales tax. Transparency falls as the number and complexity of exemptions increases. The burden of collectability falls mainly on the vendor. For out-of-state purchases, it falls on the buyer, who often does not report it. Revenues tend to be stable over time."<sup>36</sup>

Many panelists focused on the concept of broadening the sales tax base to include additional goods and services. Panelist Sheldon Laskin argued that the sales tax should encompass *all* services.<sup>37</sup> Similarly, Professor John Mikesell suggested that Indiana should expand the sales tax into a general consumption tax by taxing all household purchases for personal consumption. Professor Mikesell explained that, since 1970, Indiana's sales tax base has decreased as a share of personal income, while at the same time household consumption has increased as a share of personal income.<sup>38</sup> As the sales tax base has narrowed, the state has increased the sales tax rate to maintain the same sales tax revenue as a share of the state budget. When first adopted in 1963, the sales tax rate was 2%. In 1973, the rate increased to 4%; 10 years later the rate went up to 5%; and in the last 12 years the rate has increased twice (2002 and 2008), reaching the current 7%. Despite the ever-increasing rate, from 2002 through 2013, sales

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<sup>34</sup> See Tax Foundation, Combined State & Average Local Sales Tax Rates in 2014 chart, *available at* [http://taxfoundation.org/sites/taxfoundation.org/files/docs/state-local-sales-taxes-2014-\(large\).png](http://taxfoundation.org/sites/taxfoundation.org/files/docs/state-local-sales-taxes-2014-(large).png).

<sup>35</sup> See Tax Foundation, State and Local Sales Tax Collections Per Capita chart, *available at* [http://taxfoundation.org/sites/taxfoundation.org/files/docs/sales\\_tax\\_collections\\_2010\\_large.png](http://taxfoundation.org/sites/taxfoundation.org/files/docs/sales_tax_collections_2010_large.png).

<sup>36</sup> Justin Ross, Mercatus Center at George Mason University, *A Primer on State and Local Tax Policy*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-1.pdf>.

<sup>37</sup> See Sheldon H. Laskin discussion from the Multistate Tax Commission, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/p9gn9br6arc/?launcher=false&fcsContent=true&pbMode=normal>. See also Tim Rushenberg, *Sales Tax on Services & Double-Direct Test*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/rushenberg-whitepaper-4.pdf> (affirming Mr. Rushenberg's agreement with the contentions asserted by Mr. Laskin).

<sup>38</sup> John L. Mikesell, *Reform and Simplification of Indiana State Taxes: the Retail Sales Tax*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/whitepaper-mikesell.pdf>. See also Tim Rushenberg, *Sales Tax on Services & Double-Direct Test*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/rushenberg-whitepaper-4.pdf> (affirming Mr. Rushenberg's agreement with the contentions asserted by Prof. Mikesell).



tax receipts as a percent of total tax revenues has remained nearly constant, averaging between 39% and 45%. This equals a 250% increase in the sales tax rate over 50 years.

According to Professor Mikesell, the current sales tax system increases the complexity and administrative costs of the sales tax. Vendors must maintain separate systems for taxable and exempt purchases to guarantee proper tax collection, and administrators must verify that vendors properly distinguished between taxable and exempt purchases. For example, Indiana currently exempts household purchases of food but not candy or ready-to-eat meals. According to Professor Mikesell's position paper, this exemption reduces the tax base by roughly 15% to 20% – and regularly creates headaches for grocery and convenience stores. Moreover, according to Professor Mikesell, the food exemption primarily benefits *higher-income* households (who may purchase more or more expensive foods), rather than those families who really need relief. Mikesell proposes to tax household food but protect lower-income households in two ways: (1) exempting purchases of food made pursuant to the federal SNAP program, and (2) reinstating the tax credit/rebate system implemented in Indiana in the 1960s, which granted an individual income tax credit equal to the estimated sales tax paid on food by low-income households. By returning to this system, Indiana would dramatically expand and simplify its sales tax base, while protecting lower-income households from higher taxes.

Both Mr. Laskin and Professor Mikesell advocated expanding the sales tax base to include services. Both also stressed, however, that business inputs should remain exempt from sales taxes. Mr. Laskin used Florida's 1986 attempt to extend the sales tax to services as an example. As part of sales tax reform, Florida granted the resale exclusion *only* to those services that were directly received by the ultimate consumer, but the services purchased by service providers were subject to tax. This treatment of business inputs would have resulted in tax pyramiding. It also led out-of-state companies to complain about compliance costs associated with apportioning use taxes and in-state companies to worry about a competitive disadvantage. Florida's efforts ultimately failed, but other states have successfully expanded the tax base by addressing the concerns of the business community.<sup>39</sup>

Maurice McTigue contended that Indiana should reduce the number of exemptions from the sales tax. According to materials submitted by Mr. McTigue, "there is a positive relationship between the number of sales tax exemptions and the sales tax rate across the states."<sup>40</sup> In fact, a study relied upon by Mr. McTigue "indicates that one additional exemption is associated with an increase between 9 (0.10/1.1) and 13 (0.15/1.1) of the standard deviation in tax rates."<sup>41</sup> In other words, every new sales tax exemption leads to an increase in the sales tax rate of 0.10% -0.25%.

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<sup>39</sup> See, e.g., North Carolina, Forbes Hosts Op-ed by Scott Drenkard on North Carolina's Business Tax Climate, <http://taxfoundation.org/article/forbes-hosts-op-ed-scott-drenkard-north-carolinas-business-tax-climate>.

<sup>40</sup> Andreea Militaru & Thomas Stratmann, Mercatus Center at George Mason University, *A Survey of Sales Tax Exemptions in the States*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-2.pdf>.

<sup>41</sup> Andreea Militaru & Thomas Stratmann, Mercatus Center at George Mason University, *A Survey of Sales Tax Exemptions in the States*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-2.pdf>.

Mr. McTigue also cautions that “[h]igh tax rates increase the incentive to lobby for special exemptions. When accompanied by exemptions, higher tax rates do not necessarily lead to higher tax revenues. Our evidence that higher tax rates are associated with more tax exemptions provides one explanation about why estimates of revenue increases generated by sales tax increases are often too optimistic.” As this study suggests, Indiana’s 46 statutory exemptions from sales tax necessitate its relatively high 7% sales tax rate.

One might ask: why are so many tax scholars jumping on the band wagon of expanding the sales tax? Mr. Hubbard suggested that the sales tax is the best area to expand the base because it is transparent and relatively simple and because compliance costs are relatively low. Every time a taxpayer purchases something, the taxpayer acknowledges and accepts that a tax is assessed on that transaction. As panelist Jim Eads explained, “[s]ales taxes are often deemed ‘fair’ taxes in surveys of ordinary taxpayers, perhaps because they are thought of as pennies on the dollar.”

Despite the benefits, many panelists identified potential pitfalls with expanding the sales tax base. As Mr. Eads noted, “[p]yramiding’, i.e., the application of tax to prior tax amounts in successive commercial transactions is one problem often cited with [expanding] the sales tax. Taxing more services can actually exacerbate the problem of pyramiding of the tax. The other issue frequently cited with regard to the sales tax is the inequity created when the sales tax is applied to ‘necessities’ which account for a greater percentage of income of low-income people. This problem has been reduced in recent years as states have removed the tax from sales of food and other essential items.” Mr. Eads also noted that few states have successfully expanded the sales tax to professional services, such as medical and legal services.

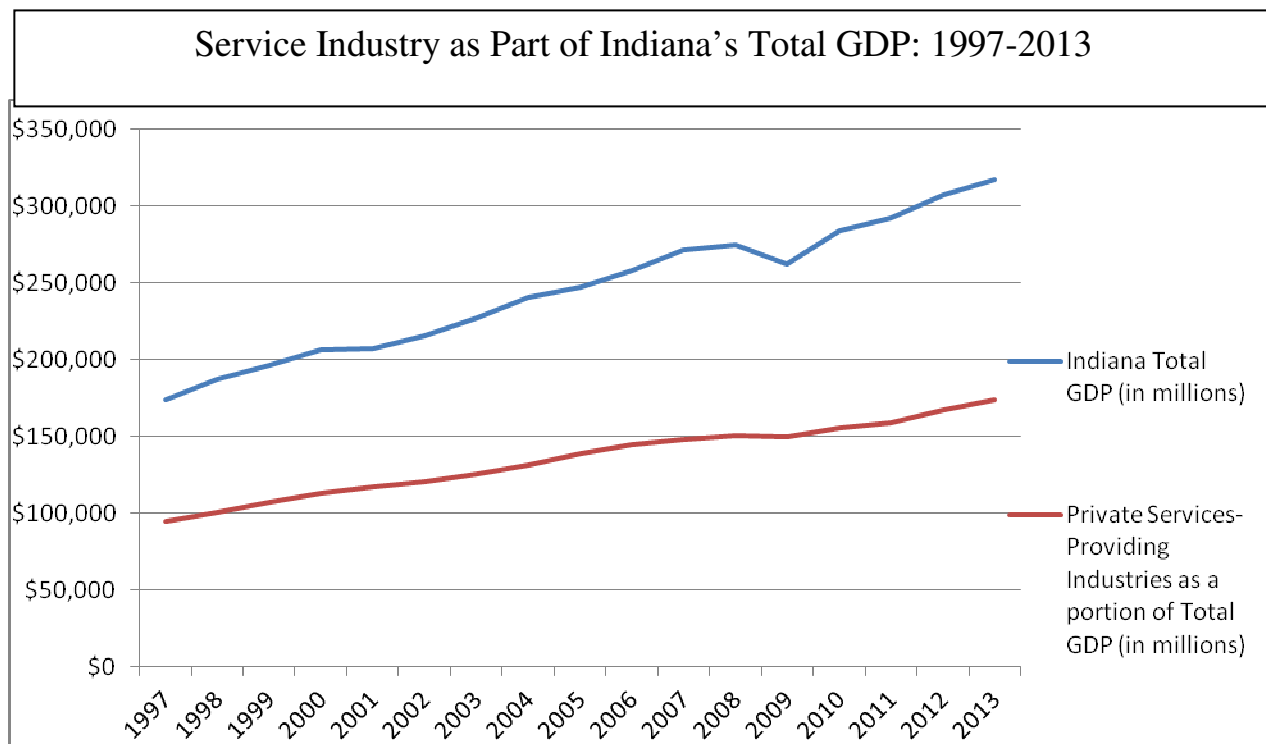
## **II. Simplification Options**

### **A. Expand the Sales Tax Base**

Almost all panelists encouraged the state to expand the sales tax base to include additional goods and services and to eliminate as many exemptions as possible. Currently, Indiana imposes sales and use tax on the sale of most goods and certain enumerated services, such as hotels, telecommunications, and cable television. Most other services, however, are not subject to sales tax. This exclusion results in a narrower tax base because the service industry has become the largest growth area, both nationwide and in Indiana.<sup>42</sup> Services now account for more than half of the state’s total GDP.

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<sup>42</sup> Allan Hubbard, President, E&A Industries, The Impact of Different Taxes on Economic Growth, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/p9gn9br6arc/?launcher=false&fcsContent=true&pbMode=normal>



The goods-services divide creates numerous problems for the state, businesses, and consumers. To offset the narrowing sales tax base, the state has continued to raise the sales tax rate. Moreover, by taxing a shrinking slice of the economy, Indiana adds to the volatility of revenue cycles. The divide also adds to businesses' compliance costs. For example, the divide results in confusion and frequent litigation about mixed transactions where a consumer purchases both a good and service at the same time, such as transactions regarding computer software or maintenance. For consumers, the divide distorts purchasing decisions. As Governor Pence explained, a consumer pays sales taxes on DVDs but not movie tickets, and on scissors but not haircuts. The divide also harms lower-income households. Wealthier taxpayers tend to consume more services – a wealthier taxpayer is more likely to pay country club fees or hire someone else to mow their lawn.

In recent years, several states have successfully applied sales taxes to a broad spectrum of services. For example, the following jurisdictions impose some form of tax, at least to some extent, on services rendered: Hawaii, Maryland, Michigan, New Jersey, New Mexico, New York, Ohio, South Dakota, Washington, and West Virginia.<sup>43</sup> Several business-friendly states,

<sup>43</sup> See also John Ketzenberger, Indiana Fiscal Policy Institute, *Sales Taxation of Services in Indiana: Concepts and Issues*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/indiana-fiscal-policy-institute-sales-tax.pdf>.

including South Dakota and Texas, tax many services.<sup>44</sup> Partially as a result of their broad sales tax base, these states impose very low or no income taxes.

For these reasons, Indiana should explore expanding the sales tax base. Indeed, Professor Mikesell proposed expanding the sales tax base to include nearly every type of retail transaction, including household food consumption. In so doing, however, Indiana should ensure that it maintains the tax system's progressivity by providing appropriate relief for lower-income households. Finally, to avoid tax pyramiding, if the sales tax is expanded, Indiana should exempt business-to-business transactions.

Of course, implementing such a system would take time and money. Many service providers currently collect no or few sales taxes as part of their businesses, and those providers would have to purchase the necessary systems to begin collecting sales taxes on all or most of their transactions. In addition, the state would have to develop and implement apportionment rules to ensure that in-state service providers are not placed at a competitive disadvantage versus out-of-state providers. As daunting as these and other challenges may seem, numerous other states have overcome them. Over the long haul, and even in the next few years, the benefits would far exceed the costs. By broadening the sales tax base, Indiana could reduce the tax code's complexity, level the playing field among businesses, and lower overall tax rates for all taxpayers.

In terms of the state's budget, the Indiana Fiscal Policy Institute (IFPI) previously estimated the fiscal impact to expand the sales tax base.<sup>45</sup> Applying the same methodology and current tax rates, an expansion of the sales tax base, while exempting business-to-business transactions, would result in an estimated increase of \$3.1 - \$3.2 billion in revenue per year. This additional revenue could be used to lower or eliminate other tax rates.

## **B. Eliminate the Double-direct Test in Favor of the Single-direct Test**

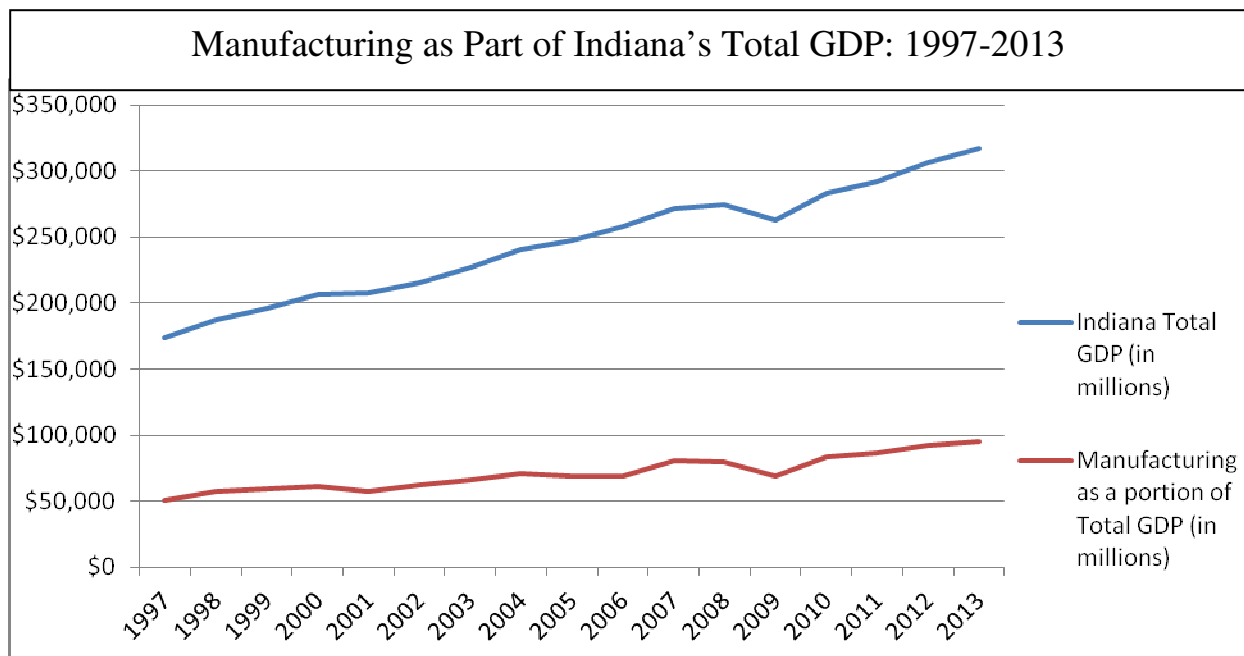
Although services continue to grow, manufacturing and agriculture still underpin much of Indiana's total GDP. In fact, countering a nationwide trend, manufacturing has risen from 29.3%<sup>46</sup> of Indiana's overall GDP in 1997 to 30.1% in 2013.<sup>47</sup> Similarly, agriculture continues to provide thousands of jobs in Indiana.

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<sup>44</sup> See also South Dakota Department of Revenue, *Sales and Use Tax Guide*, [http://dor.sd.gov/Taxes/Business\\_Taxes/Publications/PDFs/STGuide2013.pdf](http://dor.sd.gov/Taxes/Business_Taxes/Publications/PDFs/STGuide2013.pdf) and Texas Comptroller of Public Accounts Sales and Use Tax, <http://www.window.state.tx.us/taxinfo/sales/>.

<sup>45</sup> Indiana Fiscal Policy Institute, *Sales Taxation of Services in Indiana: Concepts and Issues* (2009), available at <http://indianafiscal.org/Resources/Documents/Sales-Taxation-Services-Indiana.pdf>.

<sup>46</sup> From US Department of Commerce Bureau of Economic Analysis, \$51.0 (manufacturing in millions) / \$173.9 (total IN GDP in millions) = 29.3%, available at <http://bea.gov/itable/iTable.cfm?ReqID=70&step=1#reqid=70&step=7&isuri=1&7003=200&7004=naics&7005=-1&7006=18000&7001=1200&7002=1&7090=70&7093=levels> (click on Gross Domestic Product by State, click on Gross Domestic Product, click on NAICS (1997 forward), click on All Industries, click on Indiana, select All Years).



To further assist manufacturers and farmers, Indiana should modernize its production exemption from sales taxes. As Mr. Hubbard explained, states should not tax business investments. On paper, Indiana does not tax manufacturing and agricultural investments because Indiana exempts from sales taxes materials and equipment used for manufacturing and production. In reality, however, Indiana makes it needlessly difficult for taxpayers to take advantage of these exemptions. Taxpayers must demonstrate that they acquired the property for the “*direct use in the direct production*” of the product.<sup>48</sup> This “double-direct” test is perhaps the most restrictive in the country – no other state uses it. According to panelists Tim Rushenberg and Scott Wilson, Indiana should replace the double-direct test with a single-direct test, which would simplify compliance for farmers, manufacturers, and the state.<sup>49</sup>

<sup>47</sup>From US Department of Commerce Bureau of Economic Analysis, \$95.3 (manufacturing in millions) / \$317.1 (total IN GDP in millions) = 30.1%, available at <http://bea.gov/itable/iTable.cfm?ReqID=70&step=1#reqid=70&step=7&isuri=1&7003=200&7004=naics&7005=-1&7006=18000&7001=1200&7002=1&7090=70&7093=levels> (click on Gross Domestic Product by State, click on Gross Domestic Product, click on NAICS (1997 forward), click on All Industries, click on Indiana, select All Years).

<sup>48</sup> IC 6-2.5-5-3(b).

<sup>49</sup> Tim Rushenberg, *Sales Tax on Services & Double-Direct Test*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/rushenberg-whitepaper-4.pdf> (affirming Mr. Rushenberg's agreement with the contentions asserted by Mr. Laskin); Scott Wilson, Vice President, Tax & Treasurer, Roche Diagnostics Operations, Inc., Sales and Use Tax Panel Discussion, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/pzg3dxm9nv/?launcher=false&fcsContent=true&pbMode=normal>.

From a compliance and fairness perspective, the double-direct test results in frequent disputes. The item purchased must have an “immediate effect” on the commodity being produced, not merely an “intermediate effect.” These and similarly vague terms – like “essential” and “integral” – result in confusion of which purchases qualify for the exemptions. Administering this test consumes approximately 15% - 20% of the department’s audits and up to 30% of its legal protests.

For these reasons, Indiana should join the majority of states and adopt a “single-direct” test that focuses on whether the purchase was made by a business as an input to the business’s operations. Such a concise rule would reduce taxpayers’ compliance burden and eliminate a number of confusing and contentious exemption issues.<sup>50</sup> Based on available data, this change is likely to have a negative fiscal impact of approximately \$18 - \$19 million per year.

### **C. Tax Internet Sales the Same as Other Sales**

In 2009, e-commerce generated more than \$3 trillion in commercial sales and shipments in the United States, nearly 17% of the total for all channels. Unfortunately, state governments collect only a small fraction of the taxes that are due on these sales, due both to poor compliance and certain legal restraints. Even for large retailers, compliance with the use tax in e-commerce transactions is only about 65% nationally, with Indiana averaging 67%.<sup>51</sup> Indiana loses between \$150 and \$200 million annually in sales and use tax revenue from e-commerce sales.<sup>52</sup>

Current tax law imposes the burden onto the consumer for reporting and paying taxes for online purchases in the form of a use tax. This system yields low compliance and many inconsistencies. Brick-and-mortar businesses must impose the 7% sales tax, whereas out-of-state online retailers do not.

In the 22 years since the United States Supreme Court decided *Quill*, improved technologies have reduced the tax compliance burden on remote retailers.<sup>53</sup> For instance, retailers can enlist third parties to collect and remit the tax on online purchases. States can publish taxability matrices online to assist sellers, buyers, and third-party service providers. Organizations such as the Streamlined Sales and Use Tax Project, a compact of 24 states, provide tools for all parties to promulgate rules to simplify the taxability of online sales.<sup>54</sup>

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<sup>50</sup> Scott Wilson, Vice President, Tax & Treasurer, Roche Diagnostics Operations, Inc., Sales and Use Tax Panel Discussion, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/pzg3dxm9nv/?launcher=false&fcsContent=true&pbMode=normal>.

<sup>51</sup> Donald Bruce, William F. Fox, and LeAnne Luna, *State and Local Government Sales Tax Revenue Losses from Electronic Commerce*, State Tax Notes 52(7): 552, available at <http://cber.utk.edu/ecommm/ecom0409.pdf>.

<sup>52</sup> John Ketzenberger, Michael Hicks, and Dagny Faulk, *To Collect Sales Tax or Not: Indiana’s Ecommerce Conundrum*, Indiana Fiscal Policy Institute, available at <http://www.indianafiscal.org/Resources/Documents/IFPI-Internet-Sales-Tax-11-21-11.pdf> (citing Donald Bruce, William F. Fox, and LeAnne Luna, *State and Local Government Sales Tax Revenue Losses from Electronic Commerce*, State Tax Notes 52(7): 537-558).

<sup>53</sup> See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>54</sup> See Streamlined Sales and Use Tax Project, available at <http://www.streamlinedsalestax.org> (last visited July 14, 2014).

Therefore, the General Assembly should consider legislation that ensures that all retailers collect and remit sales tax to Indiana when they sell their products to Indiana consumers. Such legislation would broaden the sales tax base and create a level playing field between out-of-state retailers and local brick-and-mortar stores. Based on studies, it is estimated that Indiana would gain approximately \$150 - \$200 million per year in revenue from taxing Internet sales, and perhaps twice that figure based on national data when other untaxed interstate sales such as catalog and phone sales are taken into account.<sup>55</sup> Additionally, Indiana should continue to support federal legislation to address these issues.

#### **D. Clarify the Taxability of Computer Software and Services**

The legislature should clarify several issues relating to computer services, such as whether and when cloud computing and software purchases are subject to sales and use tax.<sup>56</sup> These areas of commerce are growing rapidly, yet the rules remain very unclear. In general, sound tax principles suggest that certain aspects of cloud computing and software should be taxable, similar to other goods and services.

#### **E. Simplify the Recycling Exemption**

Recently, Indiana enacted new sales and use tax exemptions for recyclers.<sup>57</sup> This statute exempted the machinery, tools, equipment, and materials consumed or incorporated into recycled products. Although the statute commendably seeks to exempt business inputs from taxation, Indiana should simplify the statute to avoid needless litigation. For example, the statute contains undefined and contradictory terms to determine which taxpayers and what equipment qualifies for the exemption and defines “recycling materials” in a confusing way.

Indiana could simplify this statute by mirroring the for-hire transportation services exemption.<sup>58</sup> Under those types of provisions, any purchase by a recycling company, except those made for sales and marketing purposes, would be exempt. Such a concise rule would reduce taxpayers’ compliance burden and the state’s administrative costs.

#### **F. Clarify Tax Treatment of Construction Contracts**

In Indiana, real property construction contractors face different tax rules depending on how they bill the customer, even though the contracts are substantially the same. This differential treatment has created needless litigation and substantial compliance costs.

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<sup>55</sup> Mike Maciag, *Use Tax Revenues: How Much Are States Not Collecting?*, *Governing Magazine* (May 1, 2012), available at <http://www.governing.com/blogs/by-the-numbers/state-use-tax-collection-revenues.html>.

<sup>56</sup> Scott Wilson, Vice President, Tax & Treasurer, Roche Diagnostics Operations, Inc., Sales and Use Tax Panel Discussion, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/pzg3dxm9nv/?launcher=false&fcsContent=true&pbMode=normal>.

<sup>57</sup> IC 6-2.5-5-45.8.

<sup>58</sup> IC 6-2.5-5-27.

In general, there are two types of construction contracts for improvements to real property, lump sum contracts and time and materials contracts:

1. *Lump Sum Contracts*: Indiana deems a contractor entering into a lump sum contract the end user of all materials incorporated into the real property of the customer. As the end user, the contractor pays sales tax on the materials it purchases. When invoicing the customer on a lump sum basis, the contractor does not collect sales tax from the customer.
2. *Time and Material Contracts*: Indiana treats contractors entering into these contracts as retailers. Therefore, the contractors purchase all materials exempt from sales tax. When a contractor invoices the customer on a time and material basis, it collects sales tax on the materials. The contractor collects sales tax on the marked-up price the contractor charges for the materials.

Indiana's approach significantly burdens the contractor. The contractor must analyze every purchase and track how the purchase relates to the type of contract. Mistakes are costly because the contractor can end up paying an unnecessary 7% sales tax. Additionally, many contracts do not fall neatly into one of the two types of contracts. Time and material contracts with "not to exceed" language, contracts that rely solely on work by subcontractors, and "cost plus" contracts often blur the line. Lastly, when contractors also happen to be retail merchants, the rules become even more complex.

To simplify compliance for all real property construction contractors, Indiana should join the majority of states that tax all contracts the same.<sup>59</sup> Most states treat contractors as the end user of materials in all cases; therefore, regardless of the type of contract, the tax is imposed at the time of the contractor's purchase of the tangible personal property. This treatment would greatly ease the overall compliance burden on the contractors and the administrative burden on the state. To the extent that the state begins to tax services, the state could simplify the tax treatment of construction contracts even further.

## **G. Medical Purchase Exemptions**

When medical patients are end users of certain medical equipment, drugs, medically necessary food, and certain other medical supplies, they have an exemption from sales and use tax for these purchases. These exemptions are spread throughout a number of statutes.<sup>60</sup> These

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<sup>59</sup> Donna Niesen, CPA at Katz Zapper & Miller, *Form Over Substance: Five Steps to Meaningful Tax Reform in Indiana Without Overhauling the System*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/neison-whitepaper-1.pdf>.

<sup>60</sup> See IC 6-2.5-5-18 (exempting durable medical equipment purchased by a patient pursuant to a prescription); IC 6-2.5-5-19 (exempting certain legend drugs; non-legend drugs purchased by a patient pursuant to a prescription or to a person confined in a hospital; and all purchases of insulin, oxygen, blood, or blood plasma purchased for medical purposes); IC 6-2.5-5-19.5 (exempting certain legend drugs that are used as drug samples given to patients without charge and blood glucose monitoring devices used as samples given to patients without charge); IC 6-2.5-5-21 (exempting certain food prescribed by a doctor to a patient as medically necessary).



statutes and exemptions have different qualifications, tests, and definitions for who is entitled to, and what purchases are eligible for, the exemptions. As a result, there have been many administrative decisions and much litigation on these issues. Indiana is left with an extremely complex and difficult statutory scheme for both taxpayers and the state.

Additionally, medical technologies and practices have changed since these exemptions were first enacted. At that time, hospitals and doctor's offices were mainly in-house operations where all of the patient's needs were handled under one roof. However, today's medical practices have evolved into specialty areas where clinics, hospitals, and laboratories each perform one part of the medical practice. Plus, the types of available services have changed. Accordingly, the tax system does not properly apply to all situations similarly. The current tax system sometimes creates winners and losers for similar activities because certain property sometimes will be subject to tax, while at other times the property will be exempt.

If the legislature continues to exempt certain "medical purchases" used by the patient end user of the "medical services," then the statutes could be amended to clearly define who is eligible for the exemptions and create one standard for all types of "medical purchases." Alternatively, the legislature could broaden the tax base to tax all the property involved in "medical practices," even those consumed by the patient end users, or broaden the exemption to exempt all the property involved in "medical practices," whether used by the patient end users or the hospital and doctors. Any of these approaches would simplify the tax system.

#### **H. Clarify the Temporary Storage Statute**

As a state with a large logistics industry, Indiana has a "temporary storage exception" to the imposition of use tax.<sup>61</sup> When a taxpayer brings an item into Indiana for the sole reason of transporting that item outside Indiana for it never to return, the item will not be subject to use tax. Under current case law, however, the question remains as to what qualifies as "temporary storage," which *is not* taxable, as opposed to "storage," which *is* taxable. This open question leads to much needless uncertainty and litigation.

Indiana should define "temporary storage" as storage in Indiana for a defined period of time in Indiana for use solely outside Indiana. For example, a statute could set forth that any item that remains stored in Indiana after 60 days (or another set time period) from the date of taxpayer's purchase is considered "used" in Indiana as the item is being "stored" in Indiana. Such a bright-line test would simplify this rule and provide clearer guidance for taxpayers.

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<sup>61</sup> *Miles, Inc. v. Indiana Dep't of State Revenue*, 659 N.E.2d 1158, 1164 (Ind. Tax Ct. 1995) (finding a temporary use exception to the use tax explaining that "[i]f property is stored in Indiana for subsequent use [solely] outside Indiana, then the activities of storing, handling, and transporting the property cannot be taxed as 'uses.' To hold otherwise would subsume 'storage' within 'use' and nullify the exception for subsequent use outside Indiana").

### **III. Research and Development Exemption**

In 2013, the research and development exemption expanded broadly to include any tangible personal property that is “devoted to experimental or laboratory research and development for...products.” This broader exemption increased the types of property and uses eligible for exemption. Because the term “devoted” is undefined, this provision has confused taxpayers about what types of property and uses are exempt. Taxpayers have submitted refund claims for administrative; janitorial; and other property such as shelving, mops, and desks. Accordingly, the legislature should more clearly define the term “devoted to” research and development activities for products.

## ***Individual Income Tax***

### **I. Summary**

Prior to 1933, Indiana did not impose a state income tax on individuals and corporations. In 1933, Indiana imposed a gross income tax on the income of individuals, corporations, and other business entities.<sup>62</sup> In 1963, the General Assembly replaced this tax with a 2% adjusted gross income tax on individuals.<sup>63</sup> This rate remained largely steady until 1983, when the rate increased from 1.9% to 3%.<sup>64</sup> The rate increased to 3.4% in 1988, where it has remained steady until 2015. However, the number of modifications has steadily increased, from 5 modifications in 1963 to 32 in 2013 (plus 15 additional deductions).

Today, residents must pay both state and local income taxes if they live, work, or own a business in Indiana. At the state level, individuals must pay the adjusted gross income tax, which is currently a flat 3.4% but will fall to 3.23% by 2017. In calculating their adjusted gross income, individuals start with their federal adjusted gross income and then adjust that figure based on up to 32 state modifications.<sup>65</sup> Some of the largest deductions include a \$3,000 deduction for rent paid and a credit equal for the amount of taxes paid out of state. In 2013, Indiana received \$4.97 billion from individual income taxes, or 34% of its total revenue.

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<sup>62</sup> Acts 1933, c. 50

<sup>63</sup> Acts 1963(ss), c.32

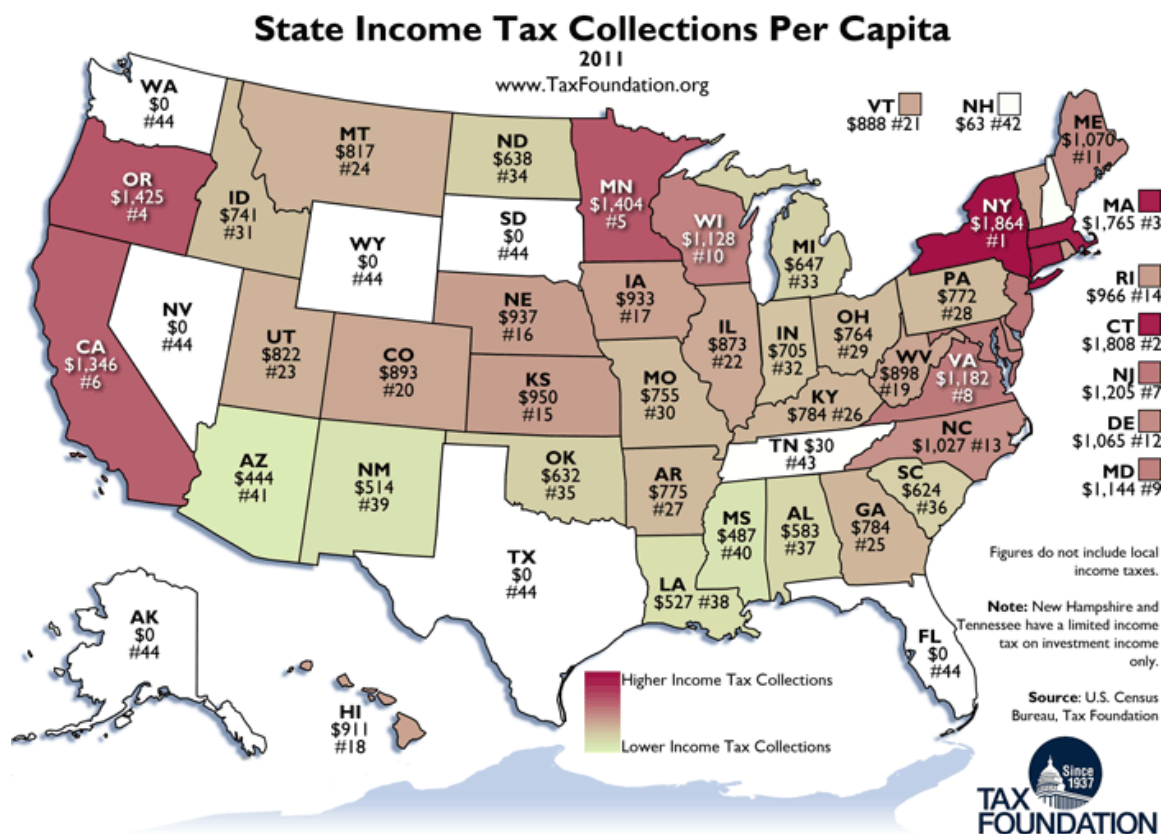
<sup>64</sup> P.L. 2-1982(ss), Sec. 8

<sup>65</sup> See Francina A. Dlouhy, Partner, Faegre Baker Daniels, *Thoughts on Tax Simplicity*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/dlouhy-whitepaper.pdf>.

At the county level, individuals generally pay the county adjusted gross income tax (CAGIT), county option income tax (COIT), or county economic development income tax (CEDIT). Each county sets its own county rate. Depending on the county, county income tax rates range from 0.2% to 3.13% (mean – 1.46%; median – 1.40%). Across the state, counties receive approximately \$1.8 billion in county income taxes.

From an administrative standpoint, individuals who are wage earners have their state and relevant county income taxes withheld from their paychecks. Employers must withhold and remit the funds to the Department of Revenue. Individuals who own businesses, whether as sole proprietors or as shareholders/partners, include that income in their adjusted gross income. For nonresident shareholders/partners, the business entity pays withholding taxes on the business income on the behalf of the shareholders/partners, who then claim credits in the amount of the withholding tax paid. Where no (or insufficient) withholding is made, individuals are required to make estimated income tax payments, with any remaining amount paid with the tax return.

In comparison with the rest of the country, Indiana imposes a slightly lower income tax burden on residents.<sup>66</sup>



<sup>66</sup> Weekly Map: State Income Tax Collections Per Capita, <http://taxfoundation.org/blog/weekly-map-state-income-tax-collections-capita>.

At the conference, panelists suggested numerous ideas for Indiana to improve its individual tax climate. Taking a broad approach, Dr. Arthur Laffer<sup>67</sup> would eliminate individual income taxes as inherently bad for a state's economic growth. In support, Mr. Laffer reviewed 11 states that had enacted an income tax in the last 50 years. He noted that every single state saw its relative contribution to the national GDP decrease. Based on this analysis, Mr. Laffer suggested that income taxes distort and inhibit economic growth.

Other research also supports Dr. Laffer's analysis. For instance, individual income taxes negatively affect migration patterns. According to Dr. Laffer, residents move to places with low taxes and high growth rates. When a person moves to a new state, his income is added to the total of all other incomes in that state. According to the Tax Foundation, between 2000 and 2010, Indiana suffered a *negative* \$3.6 billion income migration from residents leaving the state.<sup>68</sup> Although Indiana has fared better than many other states in the region, only 12 states incurred worse figures during this time. In contrast, 8 of the 9 states without an individual income tax<sup>69</sup> experienced income migration gains.

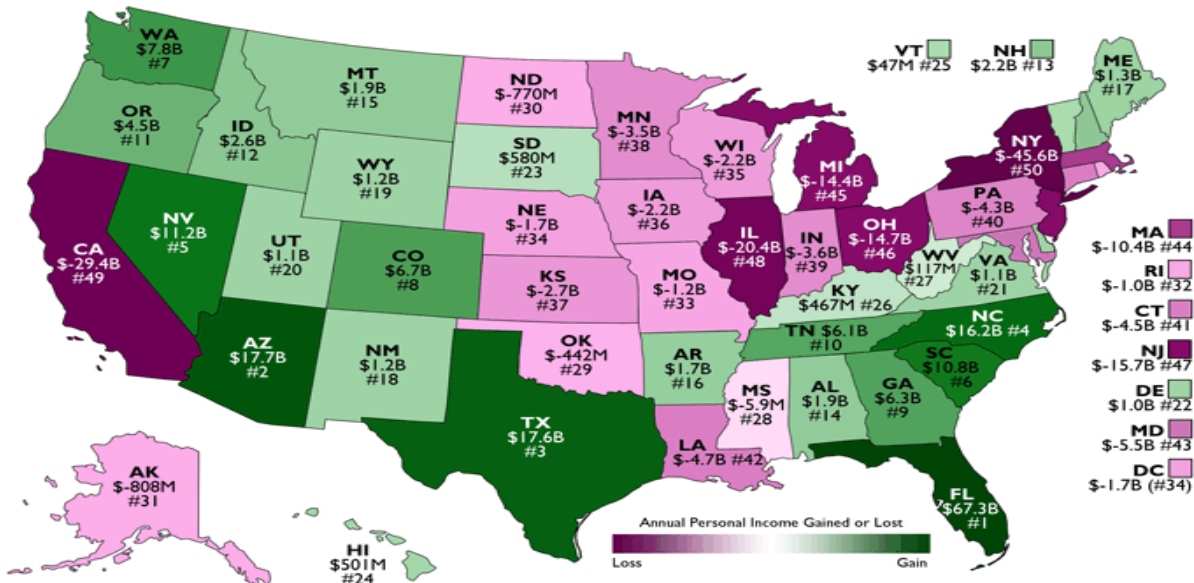
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<sup>67</sup> Dr. Arthur Laffer, chairman, The Laffer Center at the Pacific Research Institute, Keynote Speech, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/p9gn9br6arc/?launcher=false&fcsContent=true&pbMode=normal>.

<sup>68</sup> Scott Borean, Monday Map: Migration of Personal Income, <http://taxfoundation.org/blog/monday-map-migration-personal-income>.

<sup>69</sup> Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming, (note: New Hampshire and Tennessee do tax interest and dividend income).

## Migration of Personal Incomes Between States, 2000-2010



Source: IRS; Tax Foundation calculations

Note: Figures shown are the net aggregate adjusted gross income (AGI) of migrants moving into or out of states between 2000 and 2010. Figures are in real 2010 dollars. Does not include foreign migration, births, or deaths. Published August 19, 2013.

[taxfoundation.org/maps](http://taxfoundation.org/maps)

In the short term, Indiana could simplify individual taxes by eliminating many credits and deductions. As explained by panelist Dave McDaniel,<sup>70</sup> Indiana's individual tax forms are "too many – too complex."<sup>71</sup> Indeed, Indiana has one of the longest individual tax forms in the nation. The unnecessary length and complexity extends to the instruction booklet, which exceeded 60 pages in 2013. The length and complexity stems from Indiana's numerous credits, deductions, and incentives. Mr. McDaniel also noted the incredibly complex administrative process that nonresident shareholders in pass-through businesses (i.e., partnerships) must endure to comply with Indiana's individual income tax requirements.

## II. Simplification Options

Indiana could simplify individual income taxes in numerous ways. By doing so, Indiana would reduce the amount of time, and money, that Hoosiers have to spend doing their taxes.

<sup>70</sup> Dave McDaniel, CPA, Indiana CPA Society, Individual Income Tax Panel Discussion, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014) available at <http://webinar.isl.in.gov/p2tqe01d4am/?launcher=false&fcsContent=true&pbMode=normal>.

<sup>71</sup> Dave McDaniel, CPA, Indiana CPA Society, *Individual Income Tax Panel*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014) <http://www.in.gov/dor/files/mcdaniel-whitepaper-1.pdf>.

## **A. Reduce the Number of Income Tax Modifications**

As Mr. McDaniel noted, Indiana's tax forms have become unwieldy and burdensome. A long list of modifications requires the adding back or subtracting of items taken at the federal level, deductions from taxable income, and income tax credits.<sup>72</sup> In 1993, Indiana's individual tax return forms were 2 pages, with 12 pages of instructions, but by 2012, the forms had expanded to 12 pages (including optional schedules), with 63 pages of instructions. The complexity also creates a perception of unfairness because many of the modifications affect only a few taxpayers.

This complexity also imposes a high administrative burden on both taxpayers and the state. As one panelist explained, "Indiana's 'decoupling' from the Internal Revenue Code has created complexity and compliance costs for multistate taxpayers and makes Indiana less attractive" to businesses. One example involves depreciation schedules. Property purchased for business use is often depreciated over a period of years. Federal law allows for some up-front deduction of the purchase costs, with the remainder deducted over time. Beginning in 2001, however, Indiana required *separate* depreciation computations and deductions, which in turn require businesses to keep two sets of books. Another example is the earned income tax credit (EITC). Prior to 2011, Indiana's EITC was computed as a flat percentage of the existing federal EITC. Beginning in 2011, Indiana's EITC ties in with federal law in effect in 2001. This has generated 2 sets of rules, 12 pages of instructions, and a longer individual income tax return, all to determine a credit with minimal individual impact.

An ideal remedy would eliminate nearly all of the modifications, deductions, and credits. As an initial step, Indiana could eliminate some modification based on certain thresholds, such as a dollar amount or the number of taxpayer's reporting the use of them. For the depreciation deductions, Indiana could simply allow the depreciation to comport with federal income tax law. Regarding the Indiana earned income tax credit, Indiana could return to its pre-2011 rule, when the credit was based on a percentage of the federal EITC.

Assuming a 3.23% state income tax rate and a 1.29% county income tax rate, elimination of income tax addbacks, deductions, and credits is estimated to result in a revenue gain of \$472 million for state individual income tax and \$111 million for county income tax. Alternatively, these changes would allow the state's individual income tax rate to fall below 3.0%, while maintaining revenue neutrality.

## **B. Simplify Individual Income Taxation of Partnerships, S Corporations, and Limited Liability Companies**

Nonresidents face enormous complexities in filing returns for income from pass-through businesses. Individuals, who own businesses as shareholders/partners ("individual owners"),

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<sup>72</sup> Francina A. Dlouhy, Partner, Faegre Baker Daniels, *Thoughts on Tax Simplicity*, , Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/dlouhy-whitepaper.pdf>, (explaining that currently, there are 18 modifications for corporate income and 32 modifications for individual income).

include the income from that endeavor in their adjusted gross incomes. While this concept sounds simple, the current system is terribly complex. For example, where the business does not withhold the owners' income tax, individuals must pay estimated taxes, with any remaining amount paid when the tax return is filed. If the amount of taxes due at the time of filing is \$1,000 or greater, the taxpayer may face penalties and interest. Individual business owners often must depend on the business entity as to when they receive the relevant forms (the K-1 and/or WH-18) in order to file and pay the taxes in a timely manner.

The current system is also administratively burdensome. For the entities and their respective owners to report and pay the tax due from the entity's Indiana business activity, a myriad of forms and returns must be filed, including but not limited to the following: an informational income tax return by the entity reporting its Indiana income; form K-1s for each individual owner; form WH-18s withholding statements for each individual owner; monthly form WH-1 withholding tax statements; annual form WH-3 withholding tax returns; and annual composite tax returns. Under the current system, a two-person partnership has to file twenty-six different forms or returns every year.

A simpler alternative would tax the entities on their net income at the entity level. Entity level taxation would remove the entity's income from the individual income returns, and would have minimal fiscal impact for the state. This change would efficiently place the tax reporting and payment requirements in one place, the business entity that has the information and directly conducts business in Indiana. Moreover, this change would drastically reduce the number of returns and forms that taxpayers must file with the state. The business entity simply would file one income tax return, similar to the information return that it must file already. With only one tax return to handle, the state could more easily ensure that the entity properly reports and pays taxes on all of its business activity in Indiana.

An entity-level tax would have a minimal fiscal impact on the state, at most a net loss of \$10-\$15 million per year, because the income generated in a state other than Indiana generally is subject to individual income tax in the other state for which the individual is generally entitled to a credit for taxes paid to that other state. This credit has the effect of exempting most entity-level income derived outside Indiana but passing to Indiana residents.<sup>73</sup> This change also could decrease county income tax revenues by up to \$80-100 million per year, because the definitions of adjusted gross income for county income taxes start with state adjusted gross income.

### **C. Index Personal Exemptions for Inflation**

Indiana provides a \$1,000 income tax personal exemption for individuals and dependents claimed on a federal return. These deductions have not increased substantively since 1963, even though the cost of living has increased substantially. The current cost of living is 7.7 times higher than the cost of living in 1963. Inflation has resulted in a large, hidden, regressive tax increase over time that disproportionately impacts lower-income families.

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<sup>73</sup> This is for states with state-level net income taxes.

Indiana could fix this problem by indexing the exemptions to inflation. If the state indexes the personal exemptions only on a going-forward basis, this change would have only a small negative state fiscal impact, approximately \$4 million in state revenue and \$1.4 - \$1.5 million in county revenue. Increasing or indexing the personal exemptions to account for past inflation would result in a larger fiscal impact. Indexing also would move Indiana's personal exemptions closer to that of other states. Currently, 34 other states provide individual income tax exclusions for individual filers, with an average value of \$2,973. For married couples, the average exclusion is \$5,885, far above Indiana's exclusion of \$2,000.

#### **D. Loosen the Criteria for Expunging Tax Warrants**

Indiana could help individual taxpayers by loosening the circumstances in which the Department of Revenue can expunge a tax warrant. Under IC 6-8.1-8-2(h), the department may expunge a warrant only if a warrant or lien was filed because the department erred. On these occasions, the department must certify that the department's mistake led to the warrant. In some circumstances, however, there may be other good reasons to expunge a tax warrant. For example, a decades-old tax warrant can affect a homeowner's ability to refinance. Sometimes, taxpayers may receive a tax warrant when they never owed any tax at all but simply failed to update their address. Accordingly, the legislature should consider developing criteria that would allow the department to expunge tax warrants in additional situations.

#### **E. Harmonize Statutes of Limitations**

Indiana generally follows the federal government's statute of limitations rules for assessments and refund requests. A proposed assessment generally must be issued within three years of the later of the date the individual filed the return or the return's due date. Similarly, an individual generally has three years from the later of the return's due date or the date of the payment to file for a refund. The three-year limit is usually easy to administer and understand.

Certain provisions, however, confuse both the department and taxpayers. For example, IC 6-3-4-8(h) requires that an individual file a refund from wage withholding within *two* years, even though all other returns with withholding or estimated tax payments allow three years.<sup>74</sup> This divergence often misleads taxpayers into filing their returns too late. Similarly, under IC 6-8.1-9-1(f), an amended return must be filed within 180 days from the date (a) the taxpayer receives notice from the Internal Revenue Service to file the return claiming a refund, (b) three years from the original return's due date, or (c) three years from the date of the return payment, whichever is later, whenever the taxpayer receives a notice of "modification of their federal return liability" from the IRS. This requirement often misleads taxpayers into filing returns too late. Similarly, for corporate taxes, capital loss deductions are allowed to be carried back or forward, which also causes much confusion because these deductions for the carryback years may exceed the general three-year statute of limitations.

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<sup>74</sup> It should be noted that some confusion may be traced to the department's adoption of federal guidelines similar to IRC § 6511(a).



The answer is simplification. For example, in IC 6-3-4-8(h), the two-year statute of limitations should become the normal three years. IC 6-8.1-9-1(f) could be amended to require an Indiana filing when the adjustments between the IRS and the taxpayer are finalized, rather than, as now, with each *notice* of a federal modification. Lastly, a statute could allow capital loss deductions only on a carryforward basis, which would treat the capital losses similarly to how Indiana treats net operating loss deductions. This change would remove the risk of opening closed tax years normally outside the statute of limitations.

## ***Corporate Income Tax***

### **I. Summary**

Indiana imposes a flat corporate income tax on C corporations that operate in the state. Starting in 2011, the rate began to phase down from 8.5% to 4.9% by 2022. In 2013, the corporate tax provided the state with \$669 million in revenue, or 4.4% of its total revenue.

Currently, 44<sup>75</sup> states impose a corporate net income tax. Most of these states follow the federal tax model. According to materials submitted by panelist Maurice McTigue, “[t]hese systems impose large efficiency losses. They are a tax on capital, expose profits to double taxation, and dissuade small businesses from incorporating. They also encourage companies to issue debt rather than stock when raising capital.”<sup>76</sup> Additionally, when taxes are imposed on a company’s income and investments, the company passes these costs on to its customers.<sup>77</sup> Ultimately, consumers pay the taxes, even if the tax is nominally imposed on business.

Apart from C corporations, Indiana taxes S corporations, limited liability companies, and partnerships at the tax rate of the owner, which for individuals is currently a tax rate of 3.4%.<sup>78</sup> These types of business entities are known as “flow-through” entities because the tax is imposed on the income that “flows through” to the individual shareholders/partners.<sup>79</sup> As discussed in the section on individual tax, these entities report their income on “informational” returns<sup>80</sup> that report to each shareholder/partner the Indiana distributive share of income and expenses of each

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<sup>75</sup> Nevada, Ohio (for most C corporations), South Dakota, Texas, Washington, and Wyoming, are the exceptions.

<sup>76</sup> Justin Ross, Mercatus Center at George Mason University, *A Primer on State and Local Tax Policy*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-1.pdf>.

<sup>77</sup> Justin Ross, Mercatus Center at George Mason University, *A Primer on State and Local Tax Policy*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-1.pdf>.

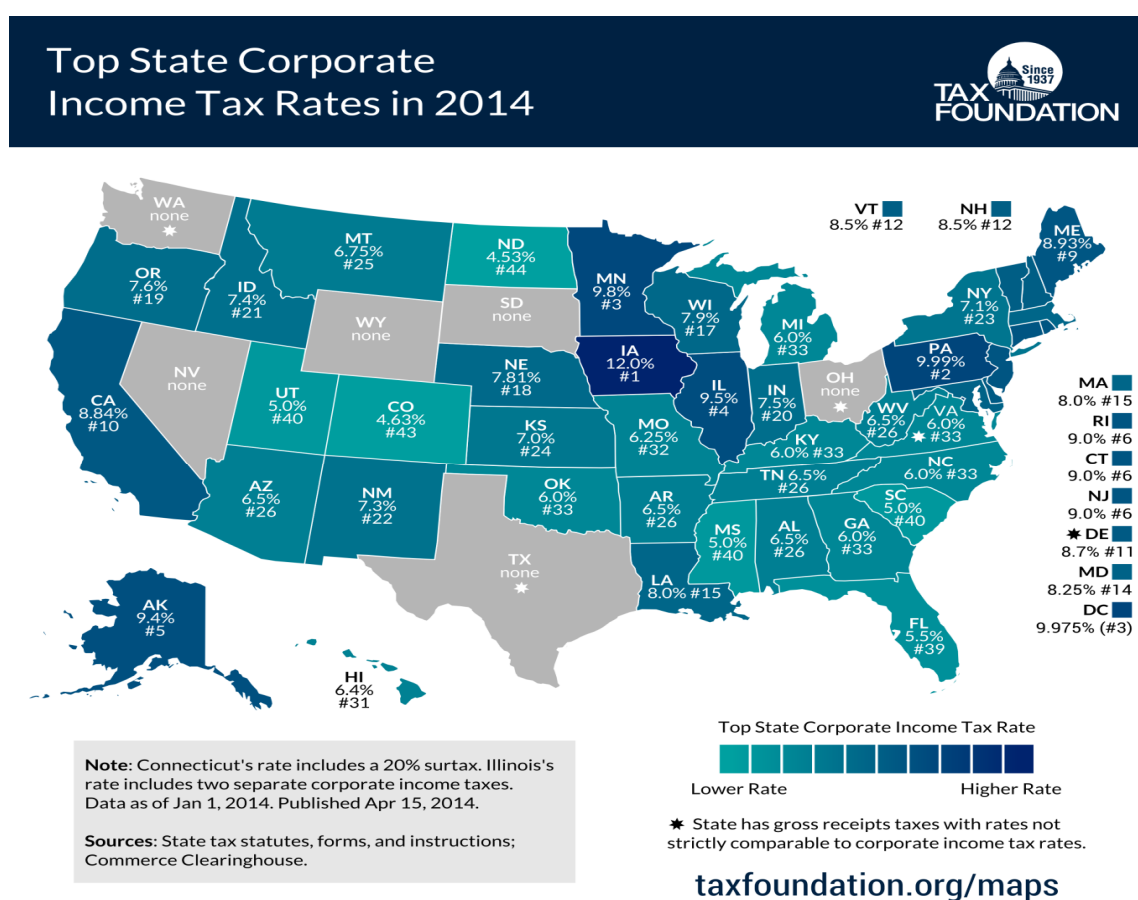
<sup>78</sup> This reference includes limited liability companies, which are treated as partnerships (if more than one member) unless the limited liability company specifically elects to be taxed as a corporation.

<sup>79</sup> Some states, however, impose an entity level tax on pass-throughs.

<sup>80</sup> The IT-20S or IT-65.

shareholder/partner.<sup>81</sup> Each shareholder/partner, in turn, then reports individual income tax based on her share of the entity's income or loss.

According to the Tax Foundation, “[c]orporate income taxes vary widely, with Iowa taxing corporate income at a top rate of 12 percent (though the state allows deductibility of federal taxes paid), followed by Pennsylvania (9.99 percent), Minnesota (9.8 percent), Illinois (9.5 percent), and Alaska (9.4 percent). On the other end of the spectrum, North Dakota taxes corporate income at a top rate of 4.53 percent, followed by Colorado (4.63 percent), Georgia, Mississippi, and Utah (5 percent).”<sup>82</sup> Some states take a different approach. Some states levy gross receipts taxes. Ohio imposes a commercial activities tax, Texas has a franchise tax, and Washington levies a business and occupation tax. Virginia and Delaware tax both gross receipts and corporate income. On the other hand, Nevada, South Dakota, and Wyoming impose neither a corporate income tax nor a gross receipts tax.



<sup>81</sup> Indiana K-1 schedule.

<sup>82</sup> <http://taxfoundation.org/blog/top-state-corporate-income-tax-rates-2014> (citing William McBride, *What Is the Evidence on Taxes and Growth?* available at <http://taxfoundation.org/article/what-evidence-taxes-and-growth>).

At the Tax Conference, several panelists questioned whether corporate income taxes could survive a cost-benefit test. Panelist Scott Drenkard pointed to empirical studies showing that corporate taxes harm economic growth more than any other tax.<sup>83</sup> Mr. Drenkard explained that these taxes are ultimately borne by consumers, employees, and shareholders in the form of higher prices, lower wages, and lower dividends. Mr. Drenkard notes that sales and real property taxes damage growth far less.<sup>84</sup>

In addition to stunting economic growth,<sup>85</sup> corporate taxes account for only a small percentage of state budgets nationwide. While consumption taxes, such as sales taxes, affect suppliers of labor and capital neutrally, corporate income taxes act like an additional or double tax on future consumption.<sup>86</sup> Furthermore, research shows that corporate tax cuts generate growth in the long run *and* expand the tax base *without* revenue loss, whereas other tax cuts, such as personal income tax cuts, may boost GDP, but at the cost of long-term lost tax revenue.

Other panelists agreed that, as currently constructed, corporate income taxes make little sense. Panelist David Brunori argued that states should tax corporate profits because companies receive the benefits of state services, but that corporate income taxes have become ineffective and inefficient.<sup>87</sup> Among other changes, Mr. Brunori suggested that Indiana adopt a default rule that requires multistate corporations to file their tax returns on a unitary or combined basis, unless the corporations can show that a combined return would unfairly reflect its income.<sup>88</sup> According to Mr. Brunori, multistate taxpayers reduce their tax liability by shifting profits to out-of-state subsidiaries, even if the corporations earned those profits in Indiana. Smaller and medium-size companies and purely in-state companies are unable to transfer profits out of state to minimize their tax liability. Combined reporting would require companies and their subsidiaries to file their income tax returns as a unitary entity, thereby preventing companies from using accounting mechanisms to avoid paying taxes on income earned in Indiana. In recent

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<sup>83</sup> Scott Drenkard, Tax Foundation, *Indiana's 2014 Tax Package Continues State's Pattern of Year-Over-Year Improvements*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/drenkard-whitepaper-1.pdf>.

<sup>84</sup> Scott Drenkard, Tax Foundation, *Indiana's 2014 Tax Package Continues State's Pattern of Year-Over-Year Improvements*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/drenkard-whitepaper-1.pdf>.

<sup>85</sup> See also Wall Street Journal, *The Lose-Lose Tax Policy Driving Away U.S. Business*, June 12, 2014 at A15; Wall Street Journal, *Inverted Thinking on Corporate Taxes*, July 17, 2014 at A13 (both articles analyze the increasing trend of U.S. companies moving their headquarters overseas due to the United States having one of the highest corporate income taxes in the world, which not only causes companies to relocate, but also prevents corporate investment and prevents economic growth).

<sup>86</sup> Top State Corporate Income Tax Rates in 2014, <http://taxfoundation.org/blog/top-state-corporate-income-tax-rates-2014> (citing William McBride, *What Is the Evidence on Taxes and Growth?* available at <http://taxfoundation.org/article/what-evidence-taxes-and-growth>).

<sup>87</sup> David Brunori, *The Politics of State Taxation: Stop Taxing Corporate Income*, State Tax Notes, July 1, 2012, available at <http://www.in.gov/dor/files/brunoriwhitepaper1.pdf>; David Brunori, *The Politics of State Taxation: Why Are We Taxing Corporate Income*, State Tax Notes, September 6, 2010, available at <http://www.in.gov/dor/files/brunoriwhitepaper2.pdf>.

years, many other states have reviewed this issue. As of July 2014, 24 states and the District of Columbia require combined reporting as part of their corporate income tax compliance. Since 2006, 8 states have adopted combined reporting. In several of these states, the legislatures adopted combined reporting as part of a comprehensive package that cut the overall corporate tax rate.

Multiple panelists noted that the current law creates uncertainty in the business community. Current law gives the Department of Revenue the authority to require a company to file on a combined basis,<sup>90</sup> but only if the department demonstrates that the company's tax return does not "fairly reflect" the company's taxable income. This standard regularly leads to protracted, expensive litigation that often takes almost a decade to resolve.

David Lewis,<sup>90</sup> another panelist, also stressed the need for constructive reforms that allow the tax system to be effective and simple. To achieve this goal, Mr. Lewis noted the need for limited use of tax incentives and credits.<sup>91</sup>

Finally, Indiana should address its corporate tax structure because the state is competing with other states and other nations. Largely due to burdensome federal corporate taxes, many companies are simply leaving the United States and relocating to low-tax countries. In just the last 10 years, 47 companies have relocated abroad, compared to only 29 companies relocating in the previous 20 years – a 62% increase in half the time.<sup>92</sup> Panelist Grover Norquist used the parable of the canary in the coal mine to explain the problem and solution. As Mr. Norquist pointed out, when a canary starts to have respiratory issues, the miners do not try to revive the canary or find an ornithologist. Instead, they recognize that the canary represents a larger problem – there, unsafe working conditions, here, an unfriendly business climate. While some national leaders have attacked the "economic patriotism" of corporations that relocate abroad, Indiana should seek to design a competitive tax system that encourages businesses to locate, grow, and create jobs here at home.

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<sup>90</sup> Citing to *A Balanced Tax Policy, One Key to Indiana's Economic Future*, Indiana University Public Policy Institute Policy Choices for Indiana's Future, February 2012, No. 11-C45, available at <http://policyinstitute.iu.edu/Uploads/PublicationFiles/State%20Local%20Tax%20Brief%20WEB.pdf>.

<sup>91</sup> Citing to *A Balanced Tax Policy, One Key to Indiana's Economic Future*, Indiana University Public Policy Institute Policy Choices for Indiana's Future, February 2012, No. 11-C45, available at <http://policyinstitute.iu.edu/Uploads/PublicationFiles/State%20Local%20Tax%20Brief%20WEB.pdf>.

<sup>92</sup> Gregory Wallace, CNN Money, *More Companies Bail on U.S. for Lower Taxes*, July 7, 2014, <http://money.cnn.com/2014/07/07/news/economy/tax-advantage-inversion/index.html>.

## ***II. Simplification Options***

### **A. Reduce Reliance on the Corporate Income Tax**

Indiana could consider lessening its reliance on the corporate income tax. Many economists believe that states should not impose corporate taxes at all. Numerous studies show that corporate taxes reduce investment, entrepreneurial activity, and productivity growth. Most damaging of all, corporate taxes strongly correlate with overall lower economic growth. According to some studies, if the United States reduced the corporate tax by 10%, it would increase GDP by 1% - 2% annually.<sup>93</sup>

By lessening its reliance on the tax, Indiana would substantially improve its business climate. According to the Tax Foundation, the top three states for corporate tax climate<sup>94</sup> have no state corporate income tax (Wyoming, South Dakota, and Nevada).<sup>95</sup> Moreover, as many of the Tax Conference panelists explained, corporate taxes are extremely difficult and expensive to administer. Businesses spend substantial resources on lawyers and accountants complying with, and often litigating, an extremely complex regulatory structure. The Department of Revenue spends enormous resources administering the tax.

### **B. Improve the Operation of the Corporate Tax**

If Indiana keeps the corporate income tax, Indiana should modernize several code provisions to improve the state's ability to collect taxes on corporate income earned in Indiana. These changes would modernize and simplify Indiana's tax code by reducing uncertainty, eliminating much needless litigation, and bringing Indiana in line with recent national trends in corporate taxation. These changes also would allow Indiana to reduce overall corporate income tax rates substantially.

#### **1. Eliminate "Throw-back" Rules**

Indiana's current "throwback" rules go hand-in-hand with the issue of combined reporting. By way of background, Indiana imposes an adjusted gross income tax on income from "sources within Indiana." When a corporation receives income from both Indiana and out-of-state sources, the amount of tax is determined by an apportionment formula based on a taxpayer's sales factor. If a corporation ships goods to a purchaser in a state in which the corporation is not subject to a corporate income tax, Indiana requires that the corporation "throw back" the sale to Indiana for purposes of determining the corporation's income tax. This rule

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<sup>93</sup> See generally William McBride, *Special Report: What Is the Evidence on Taxes and Growth?* available at <http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr207.pdf>.

<sup>94</sup> 2014 State Business Tax Climate Index, Tax Foundation, <http://taxfoundation.org/blog/map-2014-state-business-tax-climate-index>.

<sup>95</sup> State Corporate Income Tax Rates, 2000-2014, Tax Foundation, <http://taxfoundation.org/article/state-corporate-income-tax-rates>.

prevents corporations from earning “no-where income” from sales that are not subject to income tax anywhere.

The “throw-back” rule’s critics argue that the rule unfairly harms taxpayers who have structured their business with multiple subsidiaries operating in a unitary fashion. The Indiana Manufacturer’s Association states that the “throw-back” adversely affects manufacturers that export large amounts of goods overseas to foreign countries that impose no income taxes.<sup>96</sup>

According to the Indiana Economic Development Corporation (IEDC), the status quo creates circumstances under which some Indiana companies are less likely to attract certain customers, meaning lost opportunities for new jobs and investment. IEDC experienced this scenario firsthand with a company in early 2014. These opponents would like to eliminate the rule entirely,<sup>97</sup> eliminate it for sales to foreign countries,<sup>98</sup> or replace it with a “throw-out” rule that would more fairly reflect income attributed to Indiana. In the absence of other changes, Indiana would lose about \$11 - \$12 million per year if the “throw-back” rule is eliminated.<sup>99</sup>

Alternatively, Indiana could address manufacturers’ concerns by replacing the “throw-back” rule with a “throw-out” rule similar to the one adopted in New Jersey. New Jersey has a “throw-out” rule that, at least in principle, prevents corporations from structuring their sales in a way that dilutes their state income. When a taxpayer makes a sale from a New Jersey location to a state without a corporate income tax, that sale is “thrown out” of the apportionment factor in both the numerator and the denominator. A “throw-out” rule should address legitimate corporate concerns and have relatively little fiscal impact on the state.

## **2. Adopt Market-Based Sourcing of Service Receipts**

Indiana should adopt market-based sourcing of sales of services or intangibles to the customer’s location. Under this sourcing methodology, a company must account for income based on the location of the customer (where the market is).

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<sup>96</sup> *2014 Policy Guide: State & Local Tax Issue*, Indiana Manufacturer’s Association Position Paper, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), available at <http://www.in.gov/dor/files/rushenberg-whitepaper-1.pdf>.

<sup>97</sup> Mark Richards, Partner, Ice Miller LLP, *Indiana’s Tax Competitiveness and Simplification Conference* whitepaper (June 24, 2014), <http://www.in.gov/dor/files/richards-whitepaper-1.pdf>.

<sup>98</sup> Mark Richards, Partner, Ice Miller LLP, *Indiana’s Tax Competitiveness and Simplification Conference* whitepaper (June 24, 2014), <http://www.in.gov/dor/files/richards-whitepaper-1.pdf>. (proposing to eliminate the “throw-back” rule with respect to sales made to buyers outside the United States).

<sup>99</sup> Figure based on research performed the Minnesota Department of Revenue, which conducted a study that found adding a throw-back rule would produce a 2.7% increase in corporate income tax receipts (*see* Minnesota Department of Revenue, Tax Research Division, *Analysis of H.F. 37*, [http://www.revenue.state.mn.us/research\\_stats/revenue\\_analyses/2013\\_2014/hf0037\\_1.pdf](http://www.revenue.state.mn.us/research_stats/revenue_analyses/2013_2014/hf0037_1.pdf) (note, the Minnesota version of the proposed throw-back rule included services, as opposed to Indiana’s current throw-back rule that applies to only tangible personal property)).

Currently, Indiana uses the “cost of performance” method to source a company’s income. This method, which dates to the 1950s, sources a company’s receipts to where the company incurs costs, rather than to where it earns income. As a result, a company can pay little or no income tax in Indiana if the company’s primary operations are in another state. While this methodology helps large multistate companies reduce their tax liability, the local Indiana business – one that has invested in property and payroll here in Indiana – cannot use accounting mechanisms to avoid taxes. In effect, the current cost of performance methodology forces smaller and medium companies to shoulder a larger tax burden than multistate companies. As Governor Pence explained, “our tax law creates an incentive for companies to locate facilities and jobs in other states, while selling their goods and services to Hoosiers– without paying income taxes here. This law not only costs Hoosiers jobs, it effectively punishes Indiana-based companies that choose to locate their operations here in our state.”<sup>100</sup>

Market-based sourcing better aligns with today's service-based, national economy. Under market-based sourcing, receipts from transactions, other than from sales of tangible personal property, are sourced to the state of the customer’s location or where the service is performed. Because Indiana shifted to single sales factor apportionment, sourcing effectively determines the amount of taxes due. At the conference, Mr. Brunori explained that market-based sourcing is necessary to ensure a fair and effective corporate income tax.<sup>101</sup> Panelist Tony Robinson cautioned, however, that states approach market-based sourcing somewhat differently, and that these variances can yield different results.<sup>102</sup> If Indiana adopts market-based sourcing, it should study the varying approaches.

In recent years, many states have modernized their tax codes to adopt a market-based approach to sourcing sales of services or intangibles.<sup>103</sup> Eighteen other states use market-based sourcing methodology for sourcing receipts from services and other intangibles.<sup>104</sup> These states include several of Indiana’s neighbors, such as Illinois, Michigan, and Ohio. Further, this trend is accelerating, as four states have adopted market-based sourcing in 2014 alone. As a rough estimate, market-based sourcing likely would increase corporate tax revenues by 5% - 10% annually, or \$20 - \$40 million per year.

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<sup>100</sup> Governor Michael R. Pence Speech, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/governor-speech.pdf>.

<sup>101</sup> Corporate Income Tax Panel, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/p8ffczqawad/?launcher=false&fcsContent=true&pbMode=normal>.

<sup>102</sup> Corporate Income Tax Panel, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://webinar.isl.in.gov/p8ffczqawad/?launcher=false&fcsContent=true&pbMode=normal>.

<sup>103</sup> See State of Rhode Island and Providence Plantations, Department of Revenue Division of Taxation, *Tax Administrator’s Study of Combined Reporting*, pp. 65-66, available at <http://www.tax.ri.gov/Tax%20Website/TAX/reports/Rhode%20Island%20Division%20of%20Taxation%20--%20Study%20on%20Combined%20Reporting%20--%202003-17-14%20FINAL.pdf>.

<sup>104</sup> See State of Rhode Island and Providence Plantations, Department of Revenue Division of Taxation, *Tax Administrator’s Study of Combined Reporting*, pp. 65-66, available at <http://www.tax.ri.gov/Tax%20Website/TAX/reports/Rhode%20Island%20Division%20of%20Taxation%20--%20Study%20on%20Combined%20Reporting%20--%202003-17-14%20FINAL.pdf>.



### 3. Broaden the Definition of Business Income

For corporate income tax, there are two basic categories of income: business income and nonbusiness income. The Indiana Code defines “business income” as “income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.”<sup>105</sup> The term “nonbusiness income” is defined simply to mean “all income other than business income.”<sup>106</sup> “Business income” is *apportioned* amongst the states by a formula that reflects the relative amount of business activity conducted in each state in which the business operates. “Nonbusiness income” is *allocated* to the states based upon where the property generating the income in question is located.

Indiana’s approach causes several problems. As explained in materials submitted by Mr. McTigue, “[l]imiting the definition of income or raising the tax rate makes an income tax less efficient, especially since workers can move between jurisdictions.”<sup>107</sup> Unfortunately, the statutory language and case law are malleable and intensely fact-specific. As a result, the distinction between business and nonbusiness income regularly leads to uncertainty and protracted litigation.

To remedy these issues, Indiana should define “business income” to include all income apportionable under the United States Constitution. This approach is fairer and simpler for all taxpayers. In addition, this definition would allow its taxpayers to receive guidance from other state courts with similar statutory language, as well as federal courts. Finally, this change would broaden the tax base and potentially raise an additional \$20 - \$25 million per year, thereby permitting an overall cut in the corporate tax rate.

### 4. Apportion Insurance Company Adjusted Gross Income

Indiana taxes insurance revenue in a way that excludes certain premiums, even though those premiums constitute business income. Under IC 6-3-2-2(r), insurance companies are defined to include reinsurance companies and insurance companies broadly. The apportionment method, however, apportions the income based on direct premiums. Indiana has several insurance companies who have assumed premiums but not direct premiums because reinsurance companies have assumed premiums and not direct premiums. By changing the apportionment methodology, Indiana could create a more level playing field among insurance companies.

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<sup>105</sup> IC 6-3-1-20.

<sup>106</sup> IC 6-3-1-21.

<sup>107</sup> Justin Ross, Mercatus Center at George Mason University, *A Primer on State and Local Tax Policy*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-1.pdf>.



## 5. Simplify Treatment of Foreign Taxes Paid

Indiana should simplify, and move closer to the federal rule, regarding foreign income. Under IC 6-3-2-12, a taxpayer can deduct foreign source dividend income from adjusted gross income to calculate taxable Indiana income. IC 6-3-1-3.5(b)(4) permits a deduction for the dividend “gross-up” required under I.R.C. § 78. At the federal level, a taxpayer can take either a foreign dividend deduction or a foreign tax credit against the foreign source dividends. Most taxpayers choose to take the tax credit, in which case the amount of the foreign source dividend is included in the federal taxable income. Indiana enacted IC 6-3-1-3.5(b)(4) and IC 6-3-2-12 as a way to not tax most of this income, but this differs from federal law on domestic dividends.<sup>108</sup>

To simplify this issue, Indiana should repeal the foreign source dividend deduction in IC 6-3-2-12, along with the foreign dividend gross-up deduction under IC 6-3-1-3.5(d)(4), and replace it with a comparable foreign tax credit based on a taxpayer’s receipt of that foreign source dividend. The foreign tax credit would be comparable to the federal foreign tax credit found at 26 U.S.C.A. § 27. It could be calculated similarly to the federal level and be limited to a percentage of the taxpayer’s Indiana tax liability from the foreign source dividend.<sup>109</sup>

Alternatively, a corporation is entitled to deduct foreign source dividends in determining its Indiana adjusted gross income if those dividends are included in its Indiana adjusted gross income. Historically, and based on the unambiguous language of the relevant statutes, Indiana has disallowed the deductions in computing a corporation’s net operating loss. This historical treatment was recently affirmed by the Indiana Supreme Court.<sup>110</sup> Indiana’s neighbors, however, permit a “modified deduction” in determining net operating losses. Given that the relevant statutes do not permit companies to account for foreign source dividend income when calculating net operating losses, but our neighboring states do permit this, the legislature should consider harmonizing Indiana’s laws with that of its neighbors. This change could result in a negative fiscal impact of up to \$18 million annually. The exact figures are unknown but likely not significant.

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<sup>108</sup> Compare IC 6-3-2-12 with I.R.C. §§ 243-247.

<sup>109</sup> The federal foreign tax credit calculation ensures that the foreign tax credit cannot be more than the taxpayer’s total U.S. tax liability. The federal foreign tax credit is equal to the taxpayer’s total U.S. tax liability multiplied by a fraction. The numerator of the fraction is the taxpayer’s taxable income from sources outside the United States. The denominator is the taxpayer’s total taxable income from U.S. and foreign sources. Similarly, the Indiana foreign tax credit would be equal to the taxpayer’s total Indiana tax liability multiplied by a fraction, but not greater than one. The numerator of the fraction would be the taxpayer’s taxable income from foreign source dividends (i.e., the apportioned share of the dividends). The denominator would be the taxpayer’s total taxable income from Indiana, including the apportioned share of foreign source dividends.

<sup>110</sup> See *Indiana Dep’t of State Revenue v. Caterpillar, Inc.*, 49S10-1402-TA-79 (August 25, 2014), <http://www.in.gov/judiciary/opinions/pdf/08251401LHR.pdf>.

## **6. Simplify Research Credits**

Under IC 6-3.1-4-1, Indiana provides a research credit for taxpayers incurring “qualified research expenses” in Indiana. The amount of a taxpayer’s Indiana research credit ties in with federal law in effect on January 1, 2001. This oddity creates unnecessary complexities for taxpayers who must follow two sets of rules to calculate their tax credits. To resolve this problem, Indiana should either update the starting point for the federal base amount to the current federal credit or (ideally) base the state credit on a percentage of the current federal credit and Indiana economic activity.

## **7. Amend the Depreciation Method**

The IRS allows taxpayers to take depreciation deductions from the taxpayers’ annual income tax to recover the cost of certain property over the life of the property. IRC § 179 allows taxpayers to recover all or part of the cost of certain qualifying property, up to a limit, in the first year the property is placed in service. Further, IRC § 168(k) allows an additional first-year depreciation deduction for qualified property. This allowance, known as the “bonus depreciation,” is an additional deduction that can be taken after any § 179 deduction.

States differ in how they handle these deductions. Most states allow the § 179 deduction, to at least some extent, but many states disallow or otherwise limit it. Businesses often must maintain different depreciation schedules to comply with the various state requirements. Indiana, which has decoupled from the federal rules, requires individuals and businesses to maintain different depreciation schedules. This task is burdensome, costly, and overly complicated. As Maurice McTigue suggested, Indiana could significantly simplify the depreciation process by eliminating the depreciation add backs and conforming to federal law.<sup>111</sup> This change would give Indiana a competitive edge because no other regional state allows both deductions as written into the Internal Revenue Code.

In the long term, this change would have no significant fiscal impact. However, for 2015-2023, the decline in tax rates would have resulted in adding back a portion of the federal depreciation in year one (with a higher rate) followed by an equal amount of deductions in later years (at a lower rate). Reversing this is estimated to result in a net loss of approximately \$70 - \$100 million in corporate income tax revenues; \$1 million in state individual income tax revenue; and \$400,000 in county individual income tax revenue over the next seven years. Once the rate stabilizes, this will be a revenue neutral change.

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<sup>111</sup> Maurice McTigue, Mercatus Center at George Mason University, *A Primer on State and Local Tax Policy, Indiana’s Tax Competitiveness and Simplification Conference* whitepaper (June 24, 2014), <http://www.in.gov/dor/files/mctigue-whitepaper-1.pdf>.

## 8. Alternative Proposal: Revert to a Simplified Gross Receipts Tax

In 2002, Indiana repealed its gross receipts tax. In its simplest form, a gross receipts tax is a tax on the total gross revenues of a company, regardless of the company's income. At the Tax Conference, panelist Francina Dlouhy floated the idea of reinstating this tax, which can be very simple to implement.<sup>112</sup> Many other tax experts, including the Tax Foundation, argue that the gross receipts tax harms businesses by taxing them even when they earn no profits.

If Indiana adopted the Texas version of the gross receipts tax (referred to as a franchise tax), Indiana would raise approximately \$1.0 - \$1.1 billion in revenue per year.<sup>113</sup> In comparison, Indiana averages tax receipts of \$450 - \$800 million in corporate income tax and financial institutions tax, \$220 - \$240 million in utility receipts tax, \$240 - \$250 million in state individual income tax from passthrough entities, \$80 - \$90 million in county individual income tax, and \$200 - \$210 million in insurance premiums tax, for a total of \$1.2 - \$1.3 billion.<sup>114</sup> Thus, a gross receipts tax, if adopted, should be and, could be, revenue neutral.

### *Local Option Income Taxes*

#### **I. Summary**

Indiana has both state and local-level income taxes. All 92 county-level governments have the authority to enact Local Option Income Taxes (LOIT), which fall into three categories – County Economic Development Income Tax (CEDIT), County Adjusted Gross Income Tax (CAGIT), and County Option Income Tax (COIT). Each category of LOIT has its own unique set of parameters, guidelines, rates, and restrictions.

LOITs were first introduced in 1974, thereby creating the CAGIT for the purposes of reducing local government's reliance on property taxes. CAGIT consists of two parts: certified shares, which are income revenues directly available to local units, and property tax replacement credits, which reduce taxpayer liability. During the 1980s, COIT and CEDIT were introduced. Both COIT and CEDIT result in additional revenue for local governments, though the units of

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<sup>112</sup> Francina A. Dlouhy, partner, Faegre Baker Daniels, *Thoughts on Tax Simplicity*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/dlouhy-whitepaper.pdf>.

<sup>113</sup> For fiscal year ending August 31, 2013, Texas received \$4.677 billion in franchise tax revenue. See Monthly State Revenue Watch, [http://www.texas Transparency.org/State\\_Finance/Revenue/Revenue\\_Watch/](http://www.texas Transparency.org/State_Finance/Revenue/Revenue_Watch/) (last accessed August 18, 2014) (click on Historical data for monthly and annual revenue collection data). Applying a simple extrapolation of population from the 2010 census (6,483,802 divided by 25,145,561) yields \$1.206 billion. However, differences in population growth and industries may result in a lower projected revenue.

<sup>114</sup> This is based on IRS Statistics of Income for Indiana and the amount of income derived from partnerships and S corporations. See <http://www.irs.gov/uac/SOI-Tax-Stats-Historic-Table-2> (click on Indiana). The other amounts are derived from *Indiana Handbook of Taxes, Revenues, and Appropriations, Fiscal Year 2013*, available at <http://iga.in.gov/legislative/2014/publications/handbooks/> (click on fiscal year 2013).

governments allowed to benefit from this revenue may differ based on the type of LOIT. Expenditures of CEDIT revenue were originally restricted to economic development-type projects, although the use of CEDIT has been expanded in the last decade to include any general governmental purpose.

As counties have adopted LOITs, Indiana's LOIT landscape has become a veritable patchwork of 92 counties with 92 different LOIT schemes. As an example, Indiana allows counties to simultaneously impose CAGIT and CEDIT or COIT and CEDIT but prohibits a county from simultaneously imposing CAGIT and COIT. Moreover, the General Assembly has enacted special exceptions from the general LOIT rules for 17 counties. In addition to the standard LOITs, there are also special provisions variously imposing unique rate exceptions, caps, and sunset requirements among the localities. Additional subtypes of LOITs have been introduced in the past decade to further relieve the dependence of local governments on property taxes and to reduce taxpayer property tax liability. These subtypes have included homestead credits specific to the elimination of property taxes on inventory, property tax relief credits for certain types of taxpayers as designated by the county adopting body, income tax revenue used to replace allowable annual growth in maximum property tax levies, and income tax revenue for public safety.

Property tax caps have increased local government's reliance on LOITs for basic funding of services. As the exceptions to maximum rates have been allowed in statute and as other LOIT subtypes have been introduced, the LOIT statutes and adoption process have become increasingly complex. Even the adopting body for the LOIT may change depending on the type of LOITs imposed within a county. Anecdotally, many county auditors and local officials have expressed frustration with the system, often being unaware of particular provisions of significance. By simplifying and reducing the number of LOITs, Indiana could increase the flexibility for local governments and reduce the risk of future errors.

Administratively, LOITs require the cooperation of multiple state agencies to fully implement the decisions of the local officials. The Department of Revenue receives all ordinances adopting, rescinding, or modifying a LOIT and has the authority to request modifications if the ordinances contain errors. The Department of Revenue then uses these various ordinances to guide employers on the proper amount of payroll withholdings based on a taxpayer's residence as of January 1 of a given year. The Department of Revenue provides the State Budget Agency with data on processed collections on an annual basis. The State Budget Agency, in turn, uses this data to compute the total county-wide distribution for each type of LOIT within each of the 92 counties. The Department of Local Government Finance then takes the State Budget Agency's county distribution numbers and breaks them down further to the unit level, providing each local government with the amount of revenue it can anticipate receiving through each of the various LOITs. The Department of Local Government Finance also computes certain LOIT homestead credits during its budget review process, while other property tax credits are computed by the county auditor and the Auditor of State's Office during the tax billing process. The Auditor of State's Office is also involved in the distribution of LOIT revenue to the local level on a monthly basis.

## **II. Simplification Options**

### **A. Standard Adoption Ordinance**

An initial step would implement a standard ordinance for all counties, regardless of the LOIT being adopted. Currently, the statute requires certain language depending on the circumstance. While counties generally use this language, they often also add other information into the adoption ordinance, which reduces the ability of a taxpayer or official to quickly review and understand the ordinance. A standard adoption ordinance would allow for better comparability across counties and allow taxpayers to more easily gather needed information. It also would reduce administrative burdens at the state level because there would be little or no room for interpretation on the county's LOIT adoption.

### **B. Single Adopting Body**

Currently, the adopting body in a given county depends on the type of LOITs that are already adopted or the LOIT being proposed. In some situations, the county council serves as the adopting body, while in other situations, the county income tax council is the adopting body. The county income tax council is made up of each city or town in the county, along with the county unit, in proportional shares based on population. As such, in some counties, the county controls the adoption of LOITs while in other counties, the largest city or town may control the adoption of LOITs. A standard adopting body would allow for greater consistency in the adoption process and reduce confusion at the local level. It also would provide taxpayers with greater opportunity for transparency into LOIT adoptions.

### **C. Consolidation of Available LOIT Options**

As discussed previously, the LOIT statutes currently allow a variety of options, which results in different combinations of LOITs among all 92 counties. This decreases transparency and increases the administrative burden for both local units and the state.

Although many options exist, Indiana should consider consolidating all counties under one standard LOIT structure. While individual counties could still control certain aspects of the LOIT rates, all counties would have the same general structure. This structure would include two portions specific to unit shares – the first would provide shares for units throughout the county (similar to the current CAGIT and COIT); the second would provide shares only to counties and cities and towns (similar to today's CEDIT). The shares dedicated to counties and cities and towns would also include funding for public safety, if a county opts to provide a LOIT rate for public safety. The next part of the LOIT structure would be for credits, either through property tax replacement credits used to reduce property tax levies or other credits applied directly against taxpayers' property tax liability. The last part of the standard LOIT structure would allow for any special LOIT rates specific to particular counties. This would include LOITs for courthouse renovation or jail construction or operations and other exceptions currently allowed by statute.

This standard structure would give counties the flexibility to implement a LOIT that works best locally, while consolidating the underlying formulas and administration of LOITs.

As part of consolidating LOITs, the state could further simplify both LOIT and property taxation by eliminating the LOIT option that provides funding in place of maximum levy growth. Levy freeze LOITs were first implemented in 2007 and have been adopted by 11 counties thus far. Since that time, 5 counties have “thawed.” These levy freeze LOITs add complexity in the local government budgeting process, particularly in instances where the levy freeze LOIT rate is not high enough to fully fund the maximum levy growth of local units.

#### **D. Sunset of or Restrictions on the Availability of Special-use LOITs**

There currently exist multiple special exceptions for various counties. These exceptions allow a LOIT rate for various uses such as jail operations funding or courthouse renovation. In some instances, these special exceptions have sunset requirements. For other counties, the special LOIT is allowed to continue indefinitely. Where possible, the existing special exceptions should sunset without renewal. At the minimum, future special-use LOITs should be restricted or discouraged.

### ***Property Taxes***

#### **I. Summary**

Property taxes are a primary source of funding for local government units. These funds are collected at the county level and are used to pay for most functions of local government. Property taxes are an *ad valorem* tax, meaning that they are allocated to each taxpayer proportionately according to the value of the taxpayer’s property. On an annual basis, county assessors and assessors in certain townships calculate assessed values for each real property parcel in their jurisdiction. These assessed values are based on a market-value-in-use system. Personal property is assessed based on self-reported values as provided by the taxpayer to the applicable assessor. These assessed values form the foundation for property taxes in Indiana.

At the same time that assessed values are finalized, local units of government prepare their annual budgets for the ensuing year. As part of this process, local governments determine the amount of funding that must come from property tax revenue necessary to support the proposed budgets. Once adopted locally, the proposed budgets and property tax levies are reviewed by the Department of Local Government Finance to ensure they comply with statutory maximum levies and tax rates. The Department of Local Government Finance then certifies the final tax rates that will apply to all taxable property.

The county auditor then utilizes these rates to compute individual tax liability for each taxpayer. In 2010, the Indiana Constitution was amended to restrict property tax liability based on the type of property. Homestead property is capped at 1% of gross assessed value, non-homestead residential and farmland is capped at 2% of gross assessed value, and all other

property types are restricted at 3% of gross assess value. These property tax caps allow taxpayers greater consistency in their property tax bills and prevent taxpayers from experiencing significant increases in their property tax liability from year to year.

Although the State of Indiana does not tax property for its own operations (the state removed its property tax rates in 2009), local governments receive almost \$6 billion in property taxes in a given year. This figure accounts for certified property tax levies less the property tax cap credits that are provided to taxpayers and result in a reduction in funding for local governments. More than 35% of local government revenue is derived through property taxes.

In the last year, much of the discussion on property tax reform has focused on the taxation of business personal property. Property taxes on business personal property are seen as inhibiting growth and creating disincentives for companies interested in locating in Indiana. As a result, in the 2014 General Assembly session, counties were provided the option to choose whether to tax new business personal property investments. In addition, counties can choose to exempt taxpayers with a business personal property total acquisition cost of less than \$20,000. Counties can also provide enhanced tax abatement for certain new business personal property not to exceed 20 years.

In light of these changes and the discussions that occurred during the 2014 General Assembly session, several property taxation experts examined other possible options for simplification to business personal property. In addition, Jeff Quyle, of the Association of Indiana Counties, offered a local government perspective on the reduction or possible elimination of business personal property taxation. Between 2013 and 2014, business personal property accounted for approximately 15% of the taxable property in Indiana. Changes to the taxation of business personal property would present significant challenges to local governments. As Mr. Quyle explained, though the state may be more attractive to companies without a business personal property tax, replacement revenue would need to be identified for local governments. Mr. Quyle suggested that if the business personal property tax were to be eliminated, local governments could turn certain services over to the state; in the 2008 - 2009 timeframe, the state implemented additional property tax deductions and the property tax caps while assuming certain monetary responsibilities from local units. Alternatively, the business personal property tax could be left in place and the state could offer a 100% credit against businesses' state corporate income taxes. Mr. Quyle acknowledged that both proposals would require the state to identify replacement revenue for its own needs. Mr. Quyle also suggested that it may be possible to further enhance home rule for local governments, thereby allowing them to implement local sales taxes, food and beverage taxes, or severance taxes at their discretion.

## **II. Simplification Options**

### **A. Enhance Efficiency**

In Indiana, personal property is taxed, but the local assessing official assesses the personal property as it is reported by the taxpayer. Making the reporting process easier could save businesses time and money. As a representative of a business is required to file information on business personal property, Mr. Terry Flick of Kimball International, Inc., suggested a number of options that would simplify the administrative burden on both businesses and local units. These ideas included allowing business to file consolidated returns at either the county or state level, rather than the current process of filing by township. Filing by township creates a significant burden on businesses to identify the appropriate township and, in some instances, taxing district, for each reportable personal property asset. More aggregated filing would allow businesses to save time and legal expenses and would reduce the number of errors that must be corrected by local assessors during their review of the filings. In addition, Mr. Flick suggested a centralized electronic filing system for business personal property. This would create one central location for business personal property information, rather than completing property tax forms in each county in which the business is located. An electronic system could also streamline the filing process by eliminating repetitive or duplicative signature requirements and possibly eliminating certain forms by providing a more efficient way to track data through the filing process.

Mr. Flick also suggested efficiency improvements for the billing process. Currently, Indiana bills by parcel or record and, in most instances, distributes tax bills in paper form. This results in a taxpayer receiving multiple tax bills in the mail when he has more than one parcel or record. For businesses in particular, this creates an administrative burden because the business will receive separate bills for each real estate parcel and each business personal property record. The business is responsible for ensuring that it has both received and paid all of the individual bills. A mandated e-billing system could create efficiencies. In addition, e-billing could aggregate bills from multiple parcels or records into a single bill by either county or on a statewide basis, thereby reducing the need to track multiple tax bills and payments over time.

### **B. Simplify Personal Property Tax Assessment and Tax Abatements**

Ms. Francina A. Dlouhy discussed personal property assessment and tax abatements. In assessing business personal property, Indiana applies two floors to personal property assessments. The first is a non-zero value set by applying depreciation, such that property will continue to be given the final-year depreciation percentage according to the depreciation schedule used. The second is that, no matter its value according to the depreciation schedule, the property's value will be no less than 30%, even if it must be adjusted upwards, resulting in taking away depreciation. The 30% floor results in a confusing double-tier system of assessment. Adding complexity is the ability of taxpayers to request abnormal obsolescence, which allows the assessed value to drop below the 30% floor. Ms. Dlouhy asserted that the reason assessing officials deny abnormal obsolescence is that depreciation and obsolescence are afforded through



the depreciation tables, which implies that filing abnormal obsolescence is a last resort by taxpayers seeking to have their properties assessed at what they believe is true tax value without the 30% floor being applied. Ms. Dlouhy suggested revisiting the 30% floor and determining whether it is appropriate in the current economic climate. This could help to eliminate confusion on the assessment of business personal property and reduce taxpayer costs associated with filing for abnormal obsolescence.

Ms. Dlouhy also suggested simplifying the tax abatement process as a means to attract and grow business in Indiana. Currently, a business must file a statement of benefits to document the benefits that will be received by the granting of the tax abatement. The business must then also file an annual compliance with the statement of benefits, and risks losing the abatement if either the annual filing is not completed or if the benefits originally proposed have not been achieved. These filings and other aspects of the tax abatement process create additional costs and concerns for businesses. This can discourage businesses from pursuing tax abatements and growing within Indiana.

### **C. Options Concerning the Personal Property Tax**

Dr. Larry DeBoer of Purdue University addressed several other options Indiana could explore concerning the business personal property tax. These options largely focused on the elimination of the business personal property tax. Dr. DeBoer suggested that elimination could be considered either with or without revenue replacement for local governments. If revenue replacement was desired, Dr. DeBoer suggested that increases in sales taxes, LOITs, or another form of property tax as options. Each option carries its own implications for business and resident taxpayers. As such, any shift of taxation away from business personal property to another form of taxation should be carefully considered.

### **D. Transition to Taxation of Only Land**

While much of the discussion focused on business personal property taxes, Professor Justin Ross of Indiana University–Bloomington proposed an alternative means of taxing real property. Currently, taxpayers pay real estate taxes on both the value of their land and any structures or improvements that may exist on the land. Dr. Ross suggested that improvements to land no longer be taxed. Improvements would count toward the determination of gross assessed value for purposes of establishing the assessed value base and the circuit breaker cap for each property. However, in determining the net assessed value to be taxed, the value of the improvements would be deducted from the gross value, leaving only the assessed value of the land.

## ***Other Taxes and Special Taxes***

### **I. Summary**

Indiana receives significant revenue from a variety of other sources, including fuel, cigarette, utilities, financial institutions, inheritance taxes (recently repealed), insurance, riverboat gambling, and other sources.<sup>115</sup> In 2013, the total revenue approximated \$2.5 billion, more than 16% of all tax revenues.<sup>116</sup>

Most of this revenue is obtained through excise taxes and is used for specifically designated purposes. Excise taxes are indirect taxes imposed upon the sale or production of particular commodities. Unlike sales tax, excise taxes have narrow bases, applying only to one or a small group of goods or services. As such, excise taxes are discriminatory and non-neutral by their very nature. Most of the tax burden gets passed to the consumers, thereby increasing prices. Because of these characteristics, excise taxes are generally regressive. The degree of regressivity depends on the consumption patterns of each income class for the product being taxed. The lower the income of the consumer, the higher the percentage of their income gets spent on the excise taxes. For example, gas is moderately regressive because consumption is broader based, applying to personal and business consumption, and consumption tends to decline as income decreases. Conversely, alcohol excise taxes are much more regressive because the prime consumers of alcohol are individuals and alcohol is consumed at similar levels at all income levels.

### **II. Financial Institutions Tax**

Traditional financial institutions, as well as corporations that derive at least 80% of revenue from transacting the business of a financial institution in Indiana, are subject to the financial institutions tax (FIT). The tax focuses on the market in which the institution generates adjusted gross income from interest on mortgages, loans, and certain other investment income.<sup>117</sup> This tax is reported on the FIT-20 form and is paid in lieu of the corporate income tax. It is based on federal taxable income as modified and is apportioned to Indiana as required by statute. Similar to corporate taxes, the FIT rate will fall to 4.9% by 2023.

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<sup>115</sup> Figures are based on information available in the *Indiana Handbook of Taxes, Revenues, and Appropriations*, various years, available at <http://iga.in.gov/legislative/2014/publications/handbooks/> (click on each fiscal year).

<sup>116</sup> Indiana Department of Revenue Annual Report 2013, available at <http://www.in.gov/dor/reference/files/report13.pdf>.

<sup>117</sup> *MBNA America Bank, N.A. v. Indiana Dep't of State Revenue*, 895 N.E.2d 140 (Ind. Tax Ct. 2008), confirmed an economic presence standard for creating nexus for FIT purposes.

## **A. Simplification Options**

### **i. FIT–Apportionment of Partnership Income.**

As currently written, IC 6-5.5-2-8(a)(2) allows banks that are formed as partnerships to argue for choosing to apportion their partnership income twice instead of only once, in stark contrast to what every other financial institution has to do. This argument allows banks that have chosen to form a partnership to have a competitive advantage over banks that have not structured their businesses into partnerships. It also causes a great deal of confusion for administrative enforcement purposes.

A potential solution would remove the confusing language and add language to clarify the statute and thereby increase voluntary compliance, lower administrative costs, and level the playing field between partnerships and other corporate forms. Conservatively, this change should raise about \$5 million in revenue per year at current tax rates.

### **ii. Add Back of Captive REIT Dividends**

Indiana’s *adjusted gross income tax* statute contains an “add back” for any income that a corporation receives that is generated by a captive real estate investment trust (REIT). A REIT is a corporation, a trust, or an association that acts as an investment agent specializing in real estate and real estate mortgages. A captive REIT is a REIT that is owned or controlled by a single corporation. Currently, a corporate taxpayer must add back any amounts that it was able to deduct from its federal taxable income, where those amounts represent dividends paid to the corporation by a captive REIT.

Indiana’s FIT statutes do not contain the same add back for dividends generated by a captive REIT. Thus, a financial institution does not have to add back income derived in the form of dividends from a captive REIT for purposes of the financial institutions tax. By ensuring that add back income derived in the form of dividends from a captive REIT are subject to the FIT, Indiana would promote consistency with federal law. Moreover, this add back likely would have a positive fiscal impact of up to \$1 million per year.

### **iii. Include Investment Income in the Numerator**

The legislature should clarify that certain receipts should be attributed to Indiana. In 2000, a taxpayer requested a ruling from the Department on the attribution of certain receipts, notably dividends. This ruling stated that receipts not specifically attributed to Indiana were never to be attributed to Indiana. This ruling led to some absurd results, most notably the creation of nowhere income and the dilution of Indiana income.<sup>118</sup> A potential new statute should explain

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<sup>118</sup> For instance, assume a bank domiciled in Indiana earns \$100,000 in adjusted gross income and had \$900,000 in receipts without considering dividends. All the receipts are attributable to Indiana. The bank earned \$100,000 in dividends, all of which were deductible from adjusted gross income. The bank would report \$900,000 in Indiana receipts but \$1,000,000 in total receipts. Thus, the bank would have an apportionment percentage of 90% (\$900,000 divided by \$1,000,000), reducing the bank’s adjusted gross income to \$90,000. Had the bank not received the

that any other receipts of gross income, not specifically attributable to Indiana, shall be attributed to Indiana if the recipient's commercial domicile is in Indiana. The inclusion of investment income would broaden the tax base and result in approximately \$1 million in additional revenue per year.

### **III. Utility Receipts Tax**

Prior to the Utility Receipts Tax (URT), utilities were subject to the gross income tax. The URT was enacted in 2002,<sup>119</sup> the same year that the gross income tax was repealed. In addition to whatever corporate income tax reporting is required, utility providers must report URT on all gross income earned in Indiana from the sale of utility services to end users. This tax is not collected directly from customers; it is a gross receipts tax imposed upon the utility provider. Even S corporations, partnerships, and governmental units are responsible for reporting and paying the URT. The URT is imposed in addition to corporate adjusted gross income tax (AGIT) and actually resembles a sales tax, though it is paid directly by the utility and passed along to the consumer in the sales price. Neither the URT nor AGIT provides a credit for the other tax paid.

As compared to surrounding states, Indiana has one of the broadest taxes on utilities. Indiana is one of the only states that taxes utilities twice, through the corporate tax and the URT. Most states will only have one or the other, or have one offset the other. In Ohio, for instance, the public utility excise tax ranges from 4.5% to 6.75%, but Ohio has no corporate tax.<sup>120</sup>

#### **B. Simplification Options**

##### **i. Eliminate the URT**

Indiana could eliminate the utility receipts tax, as it is the only tax imposed in addition to the adjusted gross income tax on the income of a business entity of certain industries. The elimination of utility receipts tax and its companion tax, the utility services use tax, would have a negative fiscal impact of approximately \$220 - \$240 million per year.

##### **ii. Transform the URT to a Consumption Tax**

Alternatively, Indiana could transform the tax into a consumption level tax imposed on the purchaser, similar to how some other states, cities, and municipalities impose the tax.<sup>121</sup> A

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\$100,000 dividend, the bank's income would be \$100,000. If all other states followed Indiana's rule, the \$10,000 difference in adjusted gross income would be taxed by no state.

<sup>119</sup> IC 6-2.3-3-4 and IC 6-2.3-3-5.

<sup>120</sup> [http://www.tax.ohio.gov/portals/0/communications/publications/annual\\_reports/2007\\_annual\\_report/public\\_utility\\_excise\\_tax\\_07.pdf](http://www.tax.ohio.gov/portals/0/communications/publications/annual_reports/2007_annual_report/public_utility_excise_tax_07.pdf).

<sup>121</sup> See, e.g., <http://www.ibo.nyc.ny.us/iboreports/repuxtisc.html>.

consumption tax would remain revenue neutral but increase transparency for the consumer. Consumers currently pay for the URT indirectly because utilities must get approval from the Indiana Utilities Regulatory Commission for rate increases, which includes this tax burden.

#### **IV. Tobacco Excise Taxes – Cigarette and Other Tobacco Products**

Indiana currently charges an excise tax of \$0.995 per pack of cigarettes, \$0.40 per ounce of moist snuff, and 24% of the wholesale price for all other tobacco products. Indiana does not have any local excise taxes on tobacco products. Indiana collects approximately 2% of its revenue from taxes on tobacco products.

Although states can vary dramatically, no state has completely eliminated these taxes. At a minimum, Indiana should update some of its current laws to reflect the changing market, thereby making Indiana more competitive, attractive, and fair.

##### **Online Sales**

Indiana requires sellers that distribute tobacco products to be licensed as an “Other Tobacco Products” (OTP) distributor. The liability of the other tobacco products excise tax currently lies at the distribution level. Statutorily, this allows consumers to legally purchase other tobacco products from unlicensed distributors excise tax-free. These purchases are generally made through sales over the Internet from unlicensed out-of-state distributors.

Of the total tobacco product sales in the United States, 6% - 14% of those sales are Internet sales. Online sellers often do not pay any applicable state taxes. This loophole causes unfair competition, resulting in Indiana licensed distributors losing market share and the state potentially losing out on millions of dollars in revenues.

One solution would make individuals liable for the OTP and use taxes when they buy OTP for personal consumption from unlicensed distributors. Ohio takes a similar approach by imposing an excise tax on the “storage, use, or other consumption of tobacco products.”<sup>122</sup> Although this proposal would be difficult to enforce, it would provide an avenue for enforcing this tax more fairly and completely. This proposal also would generate additional tax revenue.

##### **Little Cigars**

The number and type of tobacco products has expanded in the last decade. Additionally, as tobacco products have become more heavily taxed, tobacco manufacturers have become more creative in packaging and labeling their products to avoid as much tax as possible. State tax laws have struggled to keep up. In particular, many state tax laws define tobacco in a way that potentially excludes many of the newer tobacco products on the market. For example, IC 6-7-2-5 defines “tobacco product” as “(1) any product made from tobacco, other than a cigarette (as

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<sup>122</sup> Ohio Revised Code § 5743.63.

defined in IC 6-7-1-2), that is made for smoking, chewing, or both; or (2) snuff, including moist snuff.” These and other definitions do not fully encompass many newer tobacco products, such as dissolvable tobacco, which dissolves in the mouth, and little cigars, which are cigarettes wrapped in tobacco paper.

To address these new products, Indiana should expand the definition of tobacco products. Indiana also could tax little cigars on more appropriate rates, depending on the type of product. For instance, because little cigars are essentially cigarettes, they could be taxed at the per cigarette excise tax rate.

### **E-Cigarettes**

Another new product is the electronic nicotine delivery system, more commonly known as “vapes,” “electronic cigarettes,” or “e-cigs.” E-cigs are “typically composed of a rechargeable, battery-operated heating element, a replaceable cartridge that may contain nicotine or other chemicals, and an atomizer that, when heated, converts the contents of the cartridge into a vapor.”<sup>123</sup> E-cigs first came to the U.S. market in 2004. From 2009 to 2013, the number of e-cig consumers rose from 300,000 to 3.5 million. There are close to 500 e-cig brands online with more than 7,500 flavors.<sup>124</sup>

Indiana, like most other states, does not tax e-cigs. To address these issues, Indiana could expand the definition of “Other Tobacco Products” to include all tobacco products. A broader definition would expand the tax base, level the playing field, and generate revenue for the state.

## **V. Biodiesel**

Biodiesel is a type of diesel fuel that is “manufactured from vegetable oils, animal fats, or recycled restaurant greases.”<sup>125</sup> This renewable fuel can be used in most diesel engines. Indiana currently has five biodiesel plants.<sup>126</sup> Biodiesel is subject to the special fuel tax, an excise tax found in IC 6-6-2.5. However, the special fuel tax imposes taxes based on the way petroleum-based diesel fuel is sold and distributed. Diesel fuel is distributed from a pipeline or marine vessel to a terminal or refinery, at which point it is sold over a “rack.” Biodiesel, however, is manufactured and originates in a manufacturing plant.

The General Assembly could amend certain statutes to clarify how biodiesel should be taxed, and who should collect the tax. For instance, a definition of “refinery” should include a

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<sup>123</sup> Michael Freiberg, *Options for State and Local Governments to Regulate Non-Cigarette Tobacco Products*, 21 *Annals Health L.* 407, 412.

<sup>124</sup> Survey Finds E-Cigarette Online Market on Fire, available at [http://ucsdnews.ucsd.edu/pressrelease/survey\\_finds\\_e\\_cigarette\\_online\\_market\\_on\\_fire](http://ucsdnews.ucsd.edu/pressrelease/survey_finds_e_cigarette_online_market_on_fire).

<sup>125</sup> Welcome to the Biofuels Indiana Website, <http://www.in.gov/isda/biofuels/biodiesel.html>.

<sup>126</sup> <http://www.in.gov/isda/biofuels/factsheet.pdf>.

biodiesel plant. Further, definitions for a “biodiesel manufacturer,” a “biodiesel producer,” or any sort of “biodiesel manufacturing plant” should be added to IC 6-6-2.5.

## ***Tax Incentives***

### **I. Summary**

Most states provide corporate and individual income tax credits, which lower the effective tax rates for certain individuals, industries, and investments. Tax incentives include credits, deductions, and exemptions. Policymakers create these incentives to induce certain behaviors, many of which fall under the banner of job creation and economic development. The economic development incentives are promoted as a way to provide businesses with incentives to relocate to the state and hire more employees. On balance, tax incentives are a small factor in business location decisions. A state’s overall business climate and workforce quality tend to drive business location decisions.

Most economic development income tax credits fall into one or more categories: investment tax credits, job tax credits, and research and development tax credits:

- Investment tax credits typically offer an offset against tax liability if the company invests in new property, plants, equipment, or machinery. Sometimes, the new investment will have to be “qualified” and approved by the state’s economic development office.
- Job tax credits typically offer an offset against tax liability if the company creates a specified number of jobs over a specified period of time. Sometimes, the new jobs will have to be “qualified” and approved by the state’s economic development office, to ensure that the credits apply only to new jobs in the state.
- Research and development tax credits reduce taxes due by a company that invests in “qualified” research and development activities. In theory, these tax credits encourage the kind of basic research that may not be economically justifiable in the short run, but are better for society in the long run.
- Other tax credits, such as the maternity home credit or school scholarship credit, reward different behaviors.

Administratively, Indiana requires taxpayers to apply tax credits in a specified order based upon any use limitations that exist for a credit. This allows taxpayers to maximize their opportunity to use each of the credits. First, a taxpayer must claim nonrefundable credits that cannot be carried forward. Next, a taxpayer must claim nonrefundable credits that may be carried over. Finally, a taxpayer may claim refundable tax credits such as estimated tax payments. A

taxpayer may be limited in the number of credits if an investment could qualify for multiple credits.

Increasingly, states are more rigorously analyzing the costs and benefits of tax incentive programs. In 2014, the Indiana General Assembly enacted House Bill 1020, which places all tax incentives on a regular review cycle. Each program must be reviewed at least once every five years. As of August 2014, this is a list of Indiana's credits and incentives:

- Research and Education Credits
  - Research & Development
  - Computer equipment donation
  - Teacher summer employment
  - College and university contributions
  - 21<sup>st</sup> Century Scholars Fund
  - Section 529 college savings
- Enterprise Zone Credits and Incentives
  - Enterprise zone loan interest
  - Enterprise zone area property tax reduction
  - Enterprise zone employer tax credit
- Business Development Tax Credits and Incentives
  - Industrial recovery tax credit
  - Job development / EDGE credit
  - Venture capital investment
- Hoosier business development tax credit
- Corporate headquarters relocation credit
- Energy Credits
  - Coal gasification
  - Hoosier alternative fuel vehicle manufacturer
  - Natural gas powered vehicle
- Military Base Credits
  - Military base recovery
  - Military base investment cost
- Community Revitalization Enhancement District Incentives
  - Investment credit
  - Other
- Miscellaneous
  - Historic property preservation
  - Neighborhood Assistance
  - Patent income exemption
  - Small employer qualified wellness program
  - School scholarship tax credit

In evaluating credits and incentives, policymakers must consider numerous factors, including the following:

- The complexity of the resulting tax system
- The effect on the tax base
- The impact on non-qualifying businesses
- Whether the stated economic growth goals are actually achieved
  - Did the credits serve as a competitive factor?
  - The cost of the credit and incentive program.
  - What are the unanticipated costs?



In general, tax incentives undermine the principles of sound tax policy. According to panelists Dagney Faulk and Michael Hicks, “[t]he issuance of tax incentive increases the administrative burden of the tax and also increases compliance costs if business provide reports to governments.”<sup>127</sup> Moreover, tax incentives are not neutral; they create equity issues when new or expanding businesses receive tax breaks that are not equally available to other existing businesses. Moreover, tax incentives do not drive business location decisions. As Professors Faulk and Hicks explained, “[t]ax competitiveness is one facet of general market competitiveness. Much research argues that it is one of the less important elements of competitiveness with other factors such as labor cost, human capital (education skills of workers) and stability (political, legal, and regulatory) being more important.”

On balance, little empirical evidence supports the use of tax incentives as a tool of economic development. While “statistical analysis of state tax incentives to date has been ad hoc in nature and limited to a few states where research has either gathered or had access to the appropriate data,” the research that has been performed has generally shown that a particular tax incentive’s impact on the state’s economy is “relatively small or nonexistent.” Indeed, “[o]ften policies that are implemented to make a state or local area more competitive do not have the intended effect or as large an effect as anticipated.”<sup>128</sup>

A Ball State study evaluated the costs and benefits of many credits. In the models examining the specific incentives, the EDGE tax credit resulted in “5.3 to 6.1 jobs per \$1,000 of tax credit” reported.<sup>129</sup> Therefore, “the EDGE credit appears to be relatively cost effective, in that the cost of new jobs associated with the incentive is lower than other similar programs that have been studied.”<sup>130</sup> Additionally, the study found that for the Skills Enhancement Fund, which reimburses training expenses, “each \$1,000 in state expenditures on training grants is associated with about 25 new jobs in counties with business receiving these grants.”<sup>131</sup> However, the study revealed that local property tax abatements were not as effective. On average, seven or eight new jobs are created per each \$1 million of property tax abatement in

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<sup>127</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>128</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>129</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>130</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper, at 3 (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>131</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper, at 2-3 (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

the county.<sup>132</sup> Additionally, the study found “no evidence that abatement grows the property tax base substantially over time” and merely results in countries with the highest abatements having the higher tax rates.<sup>133</sup>

Because every state offers some kind of tax incentives, however, the issue becomes “how to offer incentives in a responsible way.”<sup>134</sup> Panelist Jim Eads notes, “Some economists assert that economic incentives do not really work, i.e., businesses make decisions for reasons other than either tax policy or direct tax incentives.”<sup>135</sup> Mr. Eads further explained that “deviations from sound tax policy in pursuit of economic development, social or other goals should be well-reasoned and implemented only when established tax policies are not significantly undermined and the results of such deviations can subsequently be evaluated.”<sup>136</sup> As he noted, “[t]axes should not only be fair and equitable towards individuals and business that are similar situated, but they also must be perceived as fair by taxpayers. Individuals with the same income level should bear the same or similar tax burden. Business engaged in similar commercial activities should be subject to the same level of taxation.”<sup>137</sup>

For these reasons, Indiana is wisely reevaluating its tax incentives. Indiana Senator Brandt Hershman, Chair of the Senate Tax and Fiscal Policy Committee, explains that, “[o]ur state’s approach to date reflects Hoosier common sense: We recognize that some financial incentives for employers are necessary and effective to help the economy, but we have been deliberate in creating those incentives.”<sup>138</sup>

The Indiana Economic Development Tax Incentives Evaluation Act, which passed the House and Senate by wide margins, translates recent efforts to evaluate these incentives into law. It establishes regular evaluations of all economic development incentives, requiring that each program be reviewed every five years. “This review is required to include the amount of

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<sup>132</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper, at 3 (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>133</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>134</sup> Dagney Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>135</sup> See also Jim Eads, *Tax Simplification: Can We Get There from Here?*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/eads-whitepaper-1.pdf>.

<sup>136</sup> See also Jim Eads, *Tax Simplification: Can We Get There from Here?*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/eads-whitepaper-1.pdf>.

<sup>137</sup> See also Jim Eads, *Tax Simplification: Can We Get There from Here?*, Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/eads-whitepaper-1.pdf>.

<sup>138</sup> Brandt Hershman, Editorial, *Indiana Takes Conservative Approach to Tax Incentives*, Indianapolis Star, June 27, 2014, available at <http://www.indystar.com/story/opinion/readers/2014/06/26/indiana-takes-conservative-approach-tax-incentives/11430277/>.

benefits claimed, the economic return on investment and the policy goals for each tax incentive.”<sup>139</sup> At a basic level, it will “enhance the quality of information available to determine which incentives work, which do not, and how these programs can be improved.”<sup>140</sup>

By passing this process of evaluation into law, lawmakers directly evaluate the policy and budget impact of incentives. It “will give lawmakers the evidence they need to ensure that Hoosier taxpayers get a good return on the millions of state tax dollars spent each year on economic development incentives.”<sup>141</sup>

## **II. Potential Reforms**

### **A. Evaluate All Tax Incentives**

Indiana should continue to evaluate tax incentives. Because empirical research suggests that tax incentives provide few real economic benefits, Indiana should eliminate tax incentives that fail rigorous scrutiny.

### **B. Emphasize the State’s Support for Capital Investment**

Capital investment in new facilities and equipment is a driver of productivity and higher wages. As companies continue to invest, Indiana should recognize the full value of this investment and modify the HBI tax credit in order to compete effectively for this investment. Indiana companies often compete for capital investment under the corporate umbrella against their sister sites in other states. When corporate investment plans do not contemplate significant new job growth, the IEDC is often left in a position with no tools to compete. This is due to the fact that these companies may not have or anticipate having Indiana state tax liability that could be used to take advantage of the HBI tax credit, which incentivizes capital investment. Indiana would benefit from more effectively competing for this investment because it positions the Indiana locations of these companies for opportunities in the face of economic downturn instead of closure. Currently, HBI awards are limited to \$50 million annually. By adding a provision to the statute permitting the credit to be transferred or made refundable would increase the state’s ability to compete for investment in these scenarios, while avoiding additional fiscal exposure for the state beyond the annual limit of \$50 million.

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<sup>139</sup>Brandt Hershman, Editorial, *Indiana Takes Conservative Approach to Tax Incentives*, Indianapolis Star, June 27, 2014, available at <http://www.indystar.com/story/opinion/readers/2014/06/26/indiana-takes-conservative-approach-tax-incentives/11430277/>.

<sup>140</sup>Jeff Chapman, Pew Charitable Trusts, Editorial, *How Effective Are Tax Incentives? Indiana May Soon Find Out*, Indianapolis Star, March 7, 2014, available at <http://www.indystar.com/story/opinion/2014/03/07/how-effective-are-tax-incentives-indiana-may-soon-find-out/6183191/>; also available at Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/chapman-whitepaper-1.pdf>.

<sup>141</sup>Jeff Chapman, Pew Charitable Trusts, Editorial, *How Effective Are Tax Incentives? Indiana May Soon Find Out*, Indianapolis Star, March 7, 2014, available at <http://www.indystar.com/story/opinion/2014/03/07/how-effective-are-tax-incentives-indiana-may-soon-find-out/6183191/>; also available at Indiana’s Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/chapman-whitepaper-1.pdf>.

Conversely, the Ball State University Center for Business and Economic Research policy brief included a study of Indiana's economic development incentives offered through the IEDC. That study found "no statistically significant association between HBI and employment over the five years of data examined but recognized that a longer time period is needed to adequately assess the impact of this credit."<sup>142</sup>

### **C. Enhance Access to Capital for Indiana Small Businesses: Venture Capital Tax Credit Transferability**

Panelist Jenny Massey proposes that Indiana become more competitive by amending its treatment of venture capital tax credits. Venture capitalists "typically invest in companies that are viewed as too risky by banks [and] assist with growth by filling the gap in funding required beyond investments by family, friends, and company founders."<sup>143</sup> Indiana's current venture capital tax credit is a carryover credit allowed for the investor on the individual income tax at 20% of the investment capped at \$1,000,000. The credit can be carryforward for five years, but is not refundable or transferable. Generally, most business ventures do not make a profit for three to five years. Therefore, a credit which can only be utilized for five years for "riskier" business ventures does not seem to make economic sense if the purpose is to encourage these types of investments when the credit will most likely never be used.

Massey proposes that Indiana make the credit refundable or transferrable as most of these business ventures cannot utilize the credits because they do not have tax liabilities until after the five-year period.<sup>144</sup> Nearly half of the states offer venture capital credits in some form, and at least five states (Wisconsin, Kansas, Louisiana, South Carolina, and Kentucky) allow for transferable venture tax credits.<sup>145</sup> In any case, this credit, and all incentives, should be evaluated regularly.

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<sup>142</sup> Dagny Faulk and Michael J. Hicks, Ball State University Center for Business and Economic Research, *A Brief Examination of Tax Incentive Research*, Indiana's Tax Competitiveness and Simplification Conference whitepaper (June 24, 2014), <http://www.in.gov/dor/files/faulk-whitepaper-1.pdf>.

<sup>143</sup> Jenny Massey, FairWinds Advisors, *To Compete Indiana Must be Aggressive Adjustment to Venture Capital Credit Program Could Lead to Big Results: Transferable Tax Credits*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/massey-whitepaper-1.pdf>.

<sup>144</sup> Jenny Massey, FairWinds Advisors, *To Compete Indiana Must be Aggressive Adjustment to Venture Capital Credit Program Could Lead to Big Results: Transferable Tax Credits*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/massey-whitepaper-1.pdf>.

<sup>145</sup> Jenny Massey, FairWinds Advisors, *To Compete Indiana Must be Aggressive Adjustment to Venture Capital Credit Program Could Lead to Big Results: Transferable Tax Credits*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/massey-whitepaper-1.pdf>.

## ***Tax Administration***

Indiana's tax administration receives generally high marks from think tanks and practitioners. The Council on State Taxation gives Indiana an overall grade of "B+" based on numerous factors, including transparency, fairness to taxpayers, and the existence of an independent tax tribunal.<sup>146</sup> At the tax conference, many practitioners praised the Department of Revenue for its responsiveness to taxpayer concerns. Additionally, many practitioners offered constructive suggestions for all aspects of the tax administration process.

### **I. Reallocate Settlement Authority**

Currently, the Commissioner of the Department of Revenue has sole authority to settle administrative protests, but very limited authority to settle matters in litigation before the Tax Court.<sup>147</sup> To settle any case in litigation, settlement approval must be obtained from the Commissioner, the Attorney General, and the Governor's office. This process is complicated and time consuming. As explained by one panelist,

This delay is unwarranted and causes harm to those taxpayers who are trying to book settlement payments before quarter or year-end for GAAP or SEC reporting purposes. Second, the approval of the Governor's Office is unnecessary because, as chief executive, the Governor already exercises his authority through his agent – the Commissioner. Approvals by two executive branch authorities is redundant. Third, the approval of the Attorney General is problematic. Having the Department's own lawyer approve settlements is illogical and counterproductive in that it enables the Attorney General to disprove settlements desired by its own client, which creates potential conflict between agencies.<sup>148</sup>

Another panelist described the settlement process as "unnecessarily slow and bureaucratic, and can be simplified at no cost to the state."<sup>149</sup> For these reasons, the Commissioner of the Department of Revenue should have the independent authority to settle cases pending in Tax Court.

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<sup>146</sup> <http://taxfoundation.org/blog/council-state-taxation-grades-states-taxpayer-administration>; see also Fredrick Nicely, Counsel on State Taxation, Indiana's Tax Competitiveness and Simplification Conference Position Paper (June 24, 2014), <http://www.in.gov/dor/files/nicely-whitepaper-1.pdf>.

<sup>147</sup> See IC 4-6-2-11 and 6-8.1-3-17

<sup>148</sup> Bill Waltz, Vice President, Taxation, Indiana Chamber of Commerce, *Comments on the Tax Dispute Process*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/waltz-whitepaper-1.pdf>.

<sup>149</sup> Mark Richards, Partner, *Ice Miller*, Indiana's Tax Competitiveness and Simplification Conference Position Paper (June 24, 2014), <http://www.in.gov/dor/files/richards-whitepaper-1.pdf>.

## **II. Redefine the Role of the Attorney General's Office**

Another issue is the representation by the Office of the Attorney General in Tax Court. As one panelist asked, “to what degree the Deputy Attorney General (DAG) assigned to represent the Department of Revenue should accede to the tax policy positions of the Department in the course of litigation the dispute?”<sup>150</sup> The concern is that the Attorney General's Office may present any arguments to the Tax Court, regardless of the agency's views.

## **III. Codify the Deliberative, Attorney-Client, and Work-Product Privileges**

Taxpayer-litigants often use litigation and discovery to attempt to force the disclosure of confidential documents that reflect the state's deliberative or policy-making process, such as documents that reflect mental impressions, opinions, legal analyses, and recommendations. In a recent decision, the Tax Court held that *none* of the Department of Revenue's internal decision-making materials are protected from discovery. This decision chills the free exchange of information during the administrative process and results in administrative inefficiencies and lower quality decisions, all of which ultimately harm taxpayers.

The legislature should ensure that agencies can have confidential internal communications. Fortright communication ultimately promotes public interests and the administration of justice. Virtually every agency at both the state and federal levels enjoy some form of deliberative and attorney-client privilege. Officials will not communicate candidly among themselves if every remark or email becomes discoverable, thereby inhibiting the free flow of ideas and the incentive to challenge existing orthodoxy. For instance, if an employee thinks that the taxpayer might have a better argument than the department, the employee would hesitate to put such a view into an email, for fear that the email would be used against the department in court. To administer the tax laws effectively and consistently, government employees must enjoy a reasonable sphere of privilege.

## **IV. Increase Guidance to Taxpayers Through Letters of Finding**

When a taxpayer protests a tax assessment, the Department of Revenue hears the protest and ultimately issues a written decision in a “letter of finding.” A letter of finding resolves the specific dispute, but also can provide guidance to other taxpayers who may face similar tax situations. Therefore, these letters should provide enough factual and legal analysis so that taxpayers can rely on them.

Several panelists commented that the department should increase the accessibility and usefulness of letters of findings. As panelist Bill Waltz explained, “[c]onsistency at this level is

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<sup>150</sup> Bill Waltz, Vice President, Taxation, Indiana Chamber of Commerce, *Comments on the Tax Dispute Process*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/waltz-whitepaper-1.pdf>.

particularly important. Taxpayers need to be able to rely on the department applying the same position as has been set forth in previous Letters of Findings to subsequent like factual circumstances. Taxpayers should be confident that the law will be interpreted the same and applied the same regardless of the staff persons involved, the passage of time or how it impacts an assessment.”<sup>151</sup> More robust letters of findings would increase the department’s transparency and help taxpayers structure their protests. Another panelist commented that the department should work to improve the online searchability of letters of finding, so that taxpayers can locate relevant letters by criteria such as tax type and industry type.<sup>152</sup>

## **V. Devote More Resources to Dispute Resolution**

In 1985, the Legislature established the Tax Court to adjudicate tax disputes efficiently and expertly. The Tax Court is a court of limited jurisdiction that hears any matter arising under the tax laws of Indiana. At the conference, several presenters noted that the length of the litigation process ties up resources and inhibits planning. Due to the volume and complexity of matters filed in Tax Court, a typical case takes two years or more to resolve between filing and final resolution. At the end of 2013, there were 193 cases pending in the Tax Court, the highest number pending in the past decade. This backlog ties up tens of millions of dollars and inhibits the ability of both taxpayers and government to plan for the future. In the first quarter of 2014, there was almost \$130 million pending in tax court – \$68 million in pending assessments, and \$60 million in pending refund claims. The interest on these cases totals roughly \$3.75 million per year, or \$10,274 per day. These cases also have a broader effect on the economy as a whole. Hoosier businesses, and all level of governments, need to know the rules of the road so that they can structure their conduct, and budgets, accordingly.

For these reasons, Indiana should devote more resources to the dispute resolution process. Indiana could accomplish this task in one of several ways:

- Fund one or two new law clerk positions for the existing Tax Court;<sup>153</sup>
- Create a new small claims court, plus associated staff, to handle smaller matters;
- Designate certain existing judges who could hear tax cases; or

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<sup>151</sup> Bill Waltz, Vice President, Taxation, Indiana Chamber of Commerce, *Comments on the Tax Dispute Process*, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/waltz-whitepaper-1.pdf>.

<sup>152</sup> Francina A. Dlouhy, Partner, Faegre Baker Daniels, *Thoughts on Tax Simplicity*, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/dlouhy-whitepaper.pdf>.

<sup>153</sup> Bill Waltz noted that “[t]he productivity of an appellate level court in terms of issuing decisions correlates directly to the number of clerks and other staff available to assist the judge. Additionally, the research tools and other resources available to the court are critical. Adding staff and resources to the Tax Court offer the best remedy to the backlog and time lag.” Bill Waltz, Vice President, Taxation, Indiana Chamber of Commerce, *Comments on the Tax Dispute Process*, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/waltz-whitepaper-1.pdf>.

- Finally, as one panelist noted, among the other things that have been discussed has been the possibility of adding judges, although the panelist did not necessarily endorse this concept.

In addition to these resource issues, the legislature should consider allowing taxpayers to have an automatic right of appeal. Under the current system, neither the taxpayer nor the government has an automatic right of appeal from decisions of the Tax Court. Instead, prospective appellants must petition the Supreme Court to hear a *discretionary* appeal. Arguably, this system violates Indiana’s Constitution, which specifies that litigants shall have “in all cases an absolute right to one appeal.”<sup>154</sup> An automatic right of appeal also comports with basic notions of fairness, particularly given that tax cases often involve millions of dollars and can substantially impact both the taxpayer and the state’s finances. Taxpayers would have more confidence in the tax court system if they had the right to appeal adverse decisions, as they can in all other contexts.

## **VI. Harmonize Interest on Refunds with Interest on Delinquencies**

Pursuant to IC 6-8.1-9-2(c), interest on a refund claim begins to accrue from the date a taxpayer files a claim for refund. One panelist argued<sup>155</sup> that the state is unjustly enriched by keeping the interest earned on the potentially overpaid taxes, because interest is not calculated from the date of the overpayment. In contrast, taxpayers must pay interest on delinquencies back to the date the taxes were due. Arguably, fairness and equity require that interest paid for the entire time that the money was in the hands of the state.

## **VII. Update IRC and CFR References**

During the 2013 legislative session, the Legislative Services Agency updated the references to the Internal Revenue Code (IRC) and Code of Federal Regulations (CFR) under IC 6-3-1-11. Some of the references to the IRC were updated to relate to the document as of January 1, 2013, while at least one other reference was not updated. Additionally, the reference to the CFR also was not updated and still relates to the CFR in effect on January 1, 2011. This disconnect could lead to confusion and needless litigation. Accordingly, Indiana should update all portions of IC 6-3-1-11 to reflect a uniform date (most likely January 1, 2014).

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<sup>155</sup> Bill Waltz, Vice President, Taxation, Indiana Chamber of Commerce, *Comments on the Tax Dispute Process*, Indiana’s Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/waltz-whitepaper-1.pdf>.



## VIII. Tax Preparer Licensing

One panelist, Andrew Stadler, raised the issue of tax fraud by paid tax return preparers.<sup>156</sup> To help combat this issue, he proposed that Indiana adopt a licensing requirement for paid tax preparers in Indiana. While perhaps well-intentioned, this proposal could harm taxpayers. Consumers can hire more experienced tax preparers as they wish. Currently, only two states, Oregon and California, require paid tax preparers to be specifically licensed in that state to file tax returns. While the IRS requires all paid tax preparers to obtain a federal preparer tax information number to legally file tax returns with the IRS,<sup>157</sup> the IRS also recently tried to enact regulations that would impose requirements similar to those suggested by Mr. Stadler. These IRS regulations were struck down in *Loving, et al., v. Internal Revenue Service*, 742 F.3d 1013 (D.C. Cir. 2014).<sup>158</sup>

## IX. Standardize Administrative Protest Procedures

Indiana taxpayers have the statutory right to protest either an assessment or the denial of a tax refund. They also have a right to an administrative hearing and written decision on those contested issues. Although there are statutes and regulations for proposed assessments, additional authority regarding refund protests would clarify the process.<sup>159</sup>

Under existing law, a taxpayer has 60 days in which to challenge a proposed assessment. Taxpayers also have the right to appeal a denial of refund. Although not specifically addressed within any statute, the department has interpreted IC 6-8.1-9-1(b) and IC 6-8.1-5-1(d) as requiring that a refund appeal be submitted within 60 days of the refund denial. Following an administrative hearing, the department issues either a Memorandum of Decision in which the protest is denied in part or sustained in part, or issues a Final Order Denying Refund in which the protest is denied in its entirety. Unlike Letters of Finding, there is no requirement that these decisions be published in the Indiana Register. Similarly, no statutory provision allows taxpayers to request an administrative rehearing. The affected taxpayer's sole statutory recourse is to appeal the initial decision to the Tax Court within 90 days of the department's written

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<sup>156</sup> Andrew Stadler, President of the Indiana Society of Enrolled Agents, *Tax Preparer Licensing*, Indiana's Tax Competitiveness and Simplification Conference (June 24, 2014), <http://www.in.gov/dor/files/stadler-whitepaper-1.pdf>.

<sup>157</sup> PTIN Requirements for Tax Return Preparers, <http://www.irs.gov/Tax-Professionals/PTIN-Requirements-for-Tax-Return-Preparers> (last accessed July 17, 2014).

<sup>158</sup> Matthew Barakat, *Judge: IRS Can't Regulate Tax Preparers, Says RTRP Credential Unnecessary*, Associated Press, Jan. 18, 2013, available at <http://www.cpapracticadvisor.com/news/10855770/judge-irs-cant-regulate-tax-preparers-says-rtrp-credential-unnecessary> (last accessed July 17, 2014).

<sup>159</sup> See also Mark Richards, Partner, Ice Miller, Indiana's Tax Competitiveness and Simplification Conference Position Paper (June 24, 2014), <http://www.in.gov/dor/files/richards-whitepaper-1.pdf> (asserting a need for a legislative fix).

decision. Indiana should reconcile the procedures for protesting an assessment and protesting a refund denial to provide taxpayers a clear, certain, and parallel right to protest.

#### **X. Allow Additional Time Between Final Administrative Decision and Statute of Limitations to File Tax Court Petition**

According to at least one panelist, the General Assembly should consider expanding the time in which to file an appeal of administrative decisions with the Tax Court. The current standard – either 60 or 90 days – limits the time in which a taxpayer and the department may negotiate a settlement. The amount of time to file an appeal should increase to 120 days for both appeals of proposed assessments and claims for refund.

### **PUBLIC COMMENTS**

As part of the Tax Conference, a comment page provided an opportunity for individual Hoosiers to suggest changes to Indiana's tax laws. Below are a sampling of those comments from the public.

- Evan Bour: Indiana needs to offer a business tax credit that covers 100% of the cost of relocating a business to the state. More corporate headquarters would be a great thing for the state of Indiana and especially around Indianapolis and the I-65 corridor in Merrillville. With Chicago and Illinois hiking taxes further a program to cover the cost of relocating a business to our state would be a great boom and needs to come sooner rather than later.
- Helen Wilson: Please consider revising the IT-40 and eliminate unnecessary schedules. My IT-40 for 2013 consists of 11 pages with most of the schedules having only one entry. You could combine Schedule 1, 2, 3, 4, 5, 6, 7 and the bar code into one or two schedules and save paper, processing time, and printing time. Having 11 pages of schedules to fill out every year is ridiculous!!
- Jennifer McNett: Why does Indiana still not have the capability to file business income tax returns electronically? If we want to remain competitive, we need to offer the latest advances in technology too. Numerous business clients of our firm have complained about not being able to file their Indiana business income tax returns electronically compared to so many other states where they can.
- Shaw Friedman, Attorney: The non-partisan Multi-State Tax Commission for which 46 states are members estimates that Indiana loses approximately \$346 million a year in state tax revenues due to various multistate and multinational companies employing various dodges such transfer pricing, abuse of tax havens

and other gimmicks to avoid paying Indiana corporate taxes. Why not give all the tools necessary to our Indiana Department of Revenue including “combined reporting” and “de-coupling” to ensure that corporate taxes that are owed the state are paid, lessening the need for individual Hoosier taxpayers to have to make up the difference for these profitable entities that successfully escape paying their “fair share” of Indiana taxes?

- Derek Thomas: Expand the sales tax base to services. A less regressive way to increase state sales tax revenues in a more equitable manner would be to expand the sales tax base to include services, since low-income taxpayers pay more in sales taxes than those of higher incomes, who tend to purchase more services. For example, if an individual purchases cleaning supplies to clean their home, they pay sales tax. However, if the same individual hires a cleaning service, they do not pay any sales tax.
- Ronald Colquitt: All taxes should be levied at the point of final purchase. Then the taxpayer knows how much tax he is paying. The taxpayer approves or disapproves on Election Day with his vote. Taxes paid at any other point, in the manufacture and distribution of a product or service, is a dishonest tax purposefully being hidden from the tax payer.

Corporations, first of all, are concerned about the bottom line. An increase in the number of corporations moving to Indiana would increase the number of jobs. More jobs means more products and services purchased and would result in more taxes paid. Those taxes would take the place of the taxes repealed to attract the corporation.

If we desire a prosperous state of Indiana we need to do the thing wean do to make the business climate as desirous as possible. We have advantages, location being the most visible. All we hear about Florida is that they do not have an income tax. We can do something about that. We cannot do anything about the weather. But if we are successful enough we can vacation in The Sunshine State.

- Sheri Gross: All Hoosier workers should just pay state and county taxes individually with no deductions or exemptions.

Indiana could even lower the rate since they’ll be getting more from EVERYONE due to no deductions/exemptions. Plain and simple for everyone.

Although these comments only represent a fraction of the comments submitted to the Department, the message is clear – Indiana can do better.

## CONCLUSION

In his remarks to the Tax Conference, Governor Pence explained that tax simplification and tax fairness are two sides of the same coin. He stated as follows:

As I close, let me remind all of us that embarking on tax simplification requires courage. As we all know, many interests are embedded in the code's structure, and changing the code for the better is fraught with politics. But I know all of you believe, as do I, that we need to keep the taxpayer – who is usually a mom or a dad, a grandmother or grandfather, as well as an entrepreneur or business owner or employee – front and center in our minds. Our tax code should encourage them as they save and invest and plan for the future. The code should keep cynicism at bay and make fairness a hallmark of how we do business in Indiana.

Governor Pence also explained that, to remain competitive, Indiana has a duty to simplify its tax structure:

Finally, let me stress that, as Hoosiers, we have a duty to build upon these accomplishments. If we stand still, we will fall behind. Indiana is part of a competitive national and global economy. Many of our neighbors are working to improve their business climates, both here in the Midwest and around the country. As an American, I applaud their efforts, but as a Hoosier, I know that we have more work to do.

Hopefully, this report will serve as a resource for policymakers as they consider ways to improve Indiana's tax structure.

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### **Special Presentations—The Impact of Different Taxes on Economic Growth**

- Allan Hubbard, president, E&A Industries

### **Keynote Presentation**

- Dr. Arthur Laffer, chairman, The Laffer Center at the Pacific Research Institute

### **How to Succeed at Tax Simplification**

- John Ketzenberger (Moderator), Indiana Fiscal Policy Institute
- James Eads, Ryan & Associates (former executive director, Federation of Tax Administrators)
- Grover Norquist, Americans for Tax Reform
- Prof. Mike Hicks, Ball State Center for Business and Economic Research
- Maurice McTigue, Mercatus Center at George Mason University

### **Individual Income Tax**

- Rep. Eric Turner (Moderator)
- Prof. Lawrence Jegen, McKinney School of Law: Indiana University
- Dave McDaniel, CPA, Indiana CPA Society
- Andrew Stadler, Indiana Society of Enrolled Agents
- Mark Everson, Alliantgroup (former Commissioner of the Internal Revenue Service)

### **Tax Competitiveness**

- Victor Smith (Moderator), Indiana Secretary of Commerce
- Dagney Faulk, Center for Business and Economic Research, Ball State University
- Scott Drenkard, Tax Foundation
- Jenny Massey, FairWinds Advisors
- Jeff Chapman, Pew Charitable Trusts

### **Corporate Tax**

- Andrew Kossack (Moderator), Office of Management and Budget
- Tony Robinson, Ernst & Young
- Mike Ralston, PricewaterhouseCoopers
- David Brunori, Tax Analysts
- David Lewis, Eli Lilly and Company

**Local Tax**

- Rep Bob Cherry (Moderator)
- Prof. Larry DeBoer, Purdue University
- Jeff Quyle, Association of Indiana Counties
- Justin Ross, Indiana University—Bloomington
- Terry Flick, Kimball International, Inc.

**Sales and Use Tax**

- Sen. Luke Kenley (Moderator)
- Prof. John Mikesell, Indiana University—Bloomington
- Tim Rushenberg, Indiana Manufacturers Association
- Scott Wilson, Roche Diagnostics Operations, Inc.
- Sheldon Laskin, Multistate Tax Commission

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